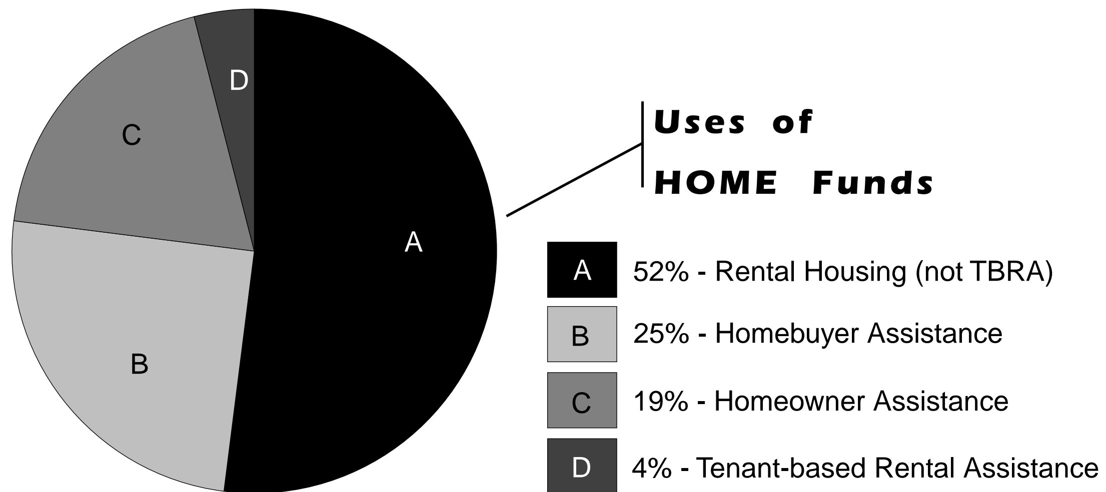
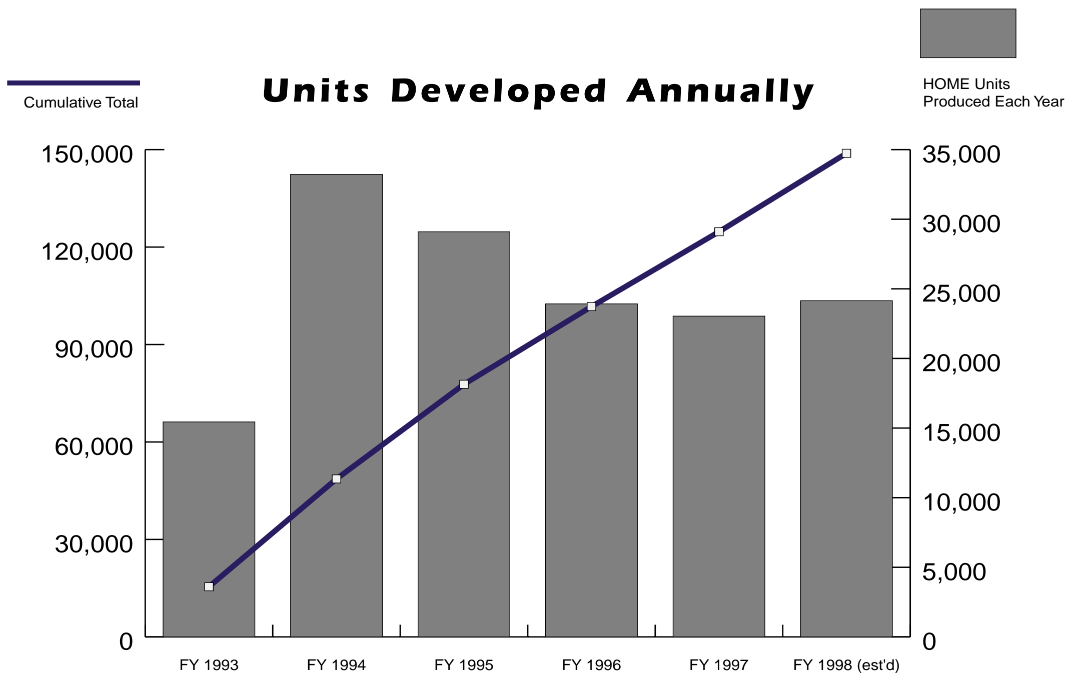
Foreword

The HOME Investment Partnership (HOME) Program offers financing for rental housing production, rental assistance programs, and homeownership programs designed to serve the needs of low-income families. More than half of all HOME funds are invested in the production of affordable rental housing. HOME funds committed in fiscal year 1999 were distributed as follows:

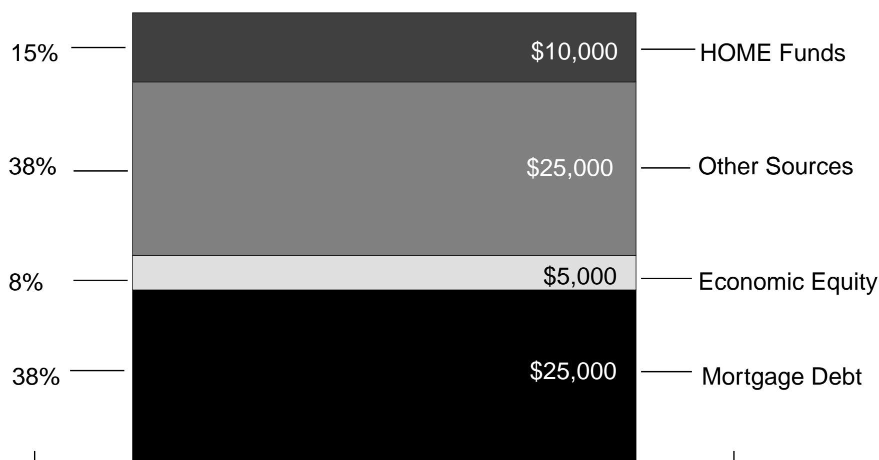


The HOME program produced its first rental housing units in fiscal year 1993 and has added a significant number of additional units each year thereafter. Through fiscal year 1998, rental housing units produced with HOME financing approached 150,000 units.



HOME funds typically cover up to twenty percent of total development costs, bridging the gap between the amount of financing that is supportable at affordable rents, and the actual cost to develop the property.

HOME Funds as a Share of Unit Development Costs



Purpose of the Model

Asset Management: Strategies for the Successful Operation of Affordable Housing, a volume in the series of HOME Program models, addresses operations issues in affordable rental housing, particularly as they impact the feasibility, underwriting, and financing processes. The model is intended to assist participating jurisdictions and affordable housing developers to create sustainable properties that will meet the needs of residents and communities, enhance community development, and remain physically viable, financially viable, and affordable over time, in accordance with the sponsors' goals.

A Word to Participating Jurisdictions

The ribbon cutting is only the beginning. Certainly, developing affordable rental housing is challenging and rewarding. However, an even more challenging task is to make sure the housing is operated so that it will meet everyone's goals.

The ribbon cutting is only the beginning.

This model will highlight the operations issues that directly affect participating jurisdictions. The model will also discuss potential strategies for dealing with these issues. Operations issues are important to participating jurisdictions because:

- Participating jurisdictions prefer to invest their HOME funds in properties that will succeed financially, physically, and operationally, over a long period of time.
- Participating jurisdictions are responsible for ensuring that the property continues to comply with HOME program requirements.
- Participating jurisdictions want to build sound local capacity to develop viable, attractive affordable housing.
- If properties run into operations problems, the community will suffer.
- Successful properties will be able to repay their HOME loans, thereby making those funds available for re-investment in other affordable housing initiatives.

Participating jurisdictions play a number of operational roles in affordable rental housing developed with HOME funds:

- As a financial partner and underwriter in the creation of the property.
- As the compliance monitor during the HOME Program affordability period.
- Potentially, intervening in a failing property.

As participating jurisdictions become more knowledgeable concerning operations issues, they will also become more successful in facilitating the development of affordable rental housing properties that meet the expectations of the community.

After the grand opening, asset managers and property managers must make sure that the property fulfills its promise.

Participating jurisdictions should take operations issues into consideration when properties are being designed and financed. This will help ensure that:

- The housing will be easier and less expensive to maintain.
- Property revenue will be sufficient to cover operating costs, not only initially, but over the long term.
- The property's sponsors and managers will be proactive asset managers, for the property and for its neighborhood.

After properties are developed, participating jurisdictions must monitor operations in order to ensure that the HOME Program requirements are being met. Perhaps more importantly, ongoing monitoring of property operations allows participating jurisdictions to anticipate problems before they occur.

A Word to Property Developers and Other Sponsors

After the grand opening, asset managers and property managers must make sure that the property fulfills its promise. This model will highlight the asset management and property management issues facing affordable rental housing. The model also suggests strategies for operational success.

Property sponsors care deeply about operations issues. For one reason, unsound operations can prevent an otherwise excellent property from fulfilling its mission. More positively, excellent operations will give properties their best chance to succeed, despite the wide range of challenges that can arise in affordable rental housing.

Operational success begins with the development process: concept, research, design, underwriting, financing, and construction. This model will pay particular attention to the need for sensible financing that is in balance with the realities of the property's affordable housing mission, the neighborhood rental housing market, and the property's operational needs.

Operational excellence also requires an understanding of the various challenges that affordable rental housing properties frequently face. Armed with this knowledge, sponsors often can take early action to avoid problems or to minimize the likelihood that they will arise. Similarly, knowledgeable sponsors will be able to spot problems earlier than sponsors who are less well informed.

Introduction

The successful development of affordable rental housing is quite a challenge, and quite a thrill. The satisfaction of the ribbon-cutting is exceeded only by the excitement of the grand opening. However, operating the property successfully over time is even more challenging. Operational success requires competent development and realistic underwriting, but even the most expertly developed property requires competent, committed, and expert operators as well.

In the United States, we have a history of more than fifty years of governmental assistance to affordable rental housing. The unfortunate reality is that many affordable rental housing properties fail to live up to the expectations of their sponsors and supporters. The enthusiasm that leads up to the grand opening is sometimes tempered when:

- there isn't enough money to replace the leaking roof; or
- the resident service package has to be slashed because of an unanticipated increase in real estate taxes; or
- drug-related crime has broken out in the neighborhood; or
- the property's mortgage loan is coming due but it cannot be refinanced because interest rates have increased.

This model is intended to help participating jurisdictions and potential sponsors create properties that achieve long-term success and to manage existing properties so problems can be avoided.

Sometimes, properties fail despite conscientious and competent effort by all concerned. Other failures could have been avoided had the management team been more aware of potential problems. Sometimes problems are created in the feasibility, approval, development, and financing processes, before the first resident moves in.

This HOME model discusses issues that typically arise in the operation of affordable rental housing. In part, it seeks to help successful existing properties become even more successful. Further, it is intended to help participating jurisdictions and potential sponsors create properties that will succeed in the future. For existing properties, it will provide insights and guidance to help minimize future problems.

Organization of the Model

This model discusses two major categories of operators: *Asset Managers* and *Property Managers*.

Various Asset Managers work for the owner, lender, and participating jurisdiction and each is charged with operational oversight to make sure that the property is achieving its strategic objectives.

Property Managers operate the property under a contract with the Property Owner. The property management staff rent the apartments, perform the maintenance, collect the rents, pay the bills, and otherwise handle the day to day operations issues.

This model addresses four major categories of asset management and property management issues that are critical to the success of affordable rental housing:

- **Operations Overview** – Because operations issues arise from the very beginning of feasibility discussions, asset management and property management specialists should be an integral part of the development team. Once the property begins rental operations, strategic operational issues arise from time to time, requiring the continued involvement of the owner and lender.
- **Sensible Financing** – Affordable rental housing requires financing that is tailored to the affordability goals of the development team and that incorporates adequate margins of safety. Otherwise, the property may experience difficulty remaining physically

viable, financially sound, and affordable over time.

- **HOME Program Compliance** – The HOME Program requires that certain residents have low incomes and pay affordable rents, and that the buildings comply with property standards, during a specified compliance period. Participating jurisdictions are required to review the compliance of properties they have financed, including on-site property inspections, with the number of units determining the frequency of such inspections.

- **Intervention To Prevent Or Remedy Problems** – Expert asset managers and property managers will detect operational problems well before they become critical, and will intervene in a timely and effective manner to ensure the property's continued success.

After reading this model, participating jurisdictions and affordable housing developers should have an improved ability to create successful properties and to support the successful operations of existing properties. Also, participating jurisdictions will be better able to evaluate the capabilities of potential development, asset management, and property management partners.

This model also includes issues facing small properties in addition to the sometimes more straightforward issues facing larger properties.

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Chapter 1

Operations Overview

The purpose of operations is to achieve the goals that the development team (including the participating jurisdiction) intended for the property. Ongoing physical and financial viability will always be prominent in the list of goals. In addition, affordable rental housing will always involve public policy goals such as rent restrictions and targeted resident populations.

Asset Management Goals for the Property

Physical Viability Over Time is the first universal goal for rental housing. The buildings have a very long useful life, and the development team intends for the buildings and dwelling units to meet acceptable maintenance standards over the entire useful life. Long-term physical viability is facilitated by good selection of materials, competent design, and competent construction. Another key factor is sensible financing that makes adequate allowances for maintenance costs (including major repairs and replacements).

Each affordable rental housing property will have its own unique strategic goals.

Financial Viability Over Time is the second universal goal. For a rental housing development to be a financial success, its income must meet its operating needs, cover its debt service payments, and provide an adequate financial return to its equity providers—and it must do so over a very extended period of time. Financial viability is facilitated by attractive design, intelligent marketing, and attentive management, which ensure the property's ability to maintain high occupancy at adequate rents. Sensible financing includes adequate allowances for rent loss, operating expenses, replacement reserves, and debt service coverage.

HOME Program Affordability Compliance will be a universal goal for properties financed under the HOME Program.

Other affordability goals are a common feature of affordable rental housing. These may include:

- **Below Market Rents** – Many sponsors want rents to be not only affordable to their intended residents but below market as well.
- **Service-Enriched Housing** – Many sponsors have concluded that affordable rental housing must go "beyond bricks and mortar" to provide non-housing services. Properties for families often create after-school programs and summer recreational programs for children, job-skill-development programs for unemployed adults, low-cost child care, and other service programs intended to support the economic and educational development of residents. Properties for seniors often bring health care and other service providers to the property, create recreational programs such as crafts classes, and arrange trips. In summary, sponsors design a mix of services that is appropriate for the residents the property intends to house, the mix of services available in the local community, and the sponsors' objectives for the property.
- **Resident Participation in Governance** – Some sponsors want residents to have a much larger voice in property operations than is typical for apartment properties. These sponsors may seek to include resident organizers on the property payroll to help residents create a democratic resident council, develop resident leadership skills, and facilitate resident empowerment.
- **Community Development** – Many properties are developed in part to advance an overall agenda of community development. Some of these properties will supplement their operating budgets with funds for community outreach and will open their non-housing service packages to residents of the larger community.
- **Role in the Sponsor's Portfolio** – Some sponsors may use earnings from one property to support other properties that have great value to the community but are economically stressed.

Relatively few operations tasks fall solely to asset managers or solely to property managers. Most tasks involve some participation from both.

Task Sharing Between Asset and Property Management			
Operations Task	Participating Jurisdiction Asset Manager	Owner's Asset Manager	Property Manager
Select Property Manager		DO	
Site Selection		DO	ADVISE
Unit Mix / Floor Plans		DO	ADVISE
Marketing / Lease-up / Management Plan		APPROVE	PROPOSE
Rent & Expense Projection		APPROVE	PROPOSE
Development Cost Projection	APPROVE	PROPOSE	
Proposed Financing	APPROVE	PROPOSE	
Annual Property Budget	REVIEW	APPROVE	PROPOSE
Expenditures Within Budget			DO
Select, Train, & Discipline Staff			DO
Increase or Decrease Staff		APPROVE	PROPOSE
Lease Units			DO
Certify Household Incomes	REVIEW		DO
Inspect Units / Property	DO	DO	DO
Collect Income			DO
Set Rents Within HOME Limits	APPROVE		DO
Enforce Leases			DO
Other Legal Actions		APPROVE	PROPOSE
Maintain Property	REVIEW	REVIEW	DO
Monthly Reports		REVIEW	DO
Annual Audits	REVIEW	REVIEW	REVIEW
Risk Management		DO	DO
Monitor Insurance	REVIEW	DO	
Refinancing	NOTIFIED	DO	ADVISE
Workout	DO	DO	ADVISE
Debt / Equity Monitoring		DO	
Negotiate Sale	APPROVE	DO	
Replace Non-Performing Owner	DO		
Replace Non-Performing Manager	NOTIFIED	DO	
Tax Rate Appeals		DO	ADVISE

Each affordable rental housing property will have its own unique strategic goals. Whatever the goals are, the development team must take the goals into account in designing and financing the property. Asset managers and property managers must be aware of the goals and must build them into long-term and short-term operating plans.

After defining the property's strategic goals, sponsors begin creating an asset management plan to incorporate those goals into the day-to-day operation of the property. The asset management plan will be customized to the individual property but will be based on a relatively small number of time-tested strategies for asset management success.

Strategies for Asset Management Success

The role of a real estate asset manager varies greatly, depending on:

- the type of real estate being managed;
- whether the asset manager works for an owner, a lender, or a regulatory agency; and
- the strategic objectives of the property.

Successful asset managers follow the guideline "steer, don't row."

However, all successful asset managers employ the following ten strategies to produce operational success.

Make Focus Strategic, Not Tactical. Asset managers must concern themselves with the big picture issues, such as property mission, property value, refinancing, workout, and sale. Asset managers must develop strategies for achieving these big picture results. Property managers carry out the strategy through such tactical measures as staffing, marketing, maintenance, budgets, financial review, and reporting. Properties run into trouble when the asset manager becomes enmeshed in tactics: not only does this frustrate the property manager and cause needless loss of effectiveness, it also means that no one is paying attention to the strategic issues. Successful asset managers follow the guideline "steer, don't row."

Focus on Results. Successful asset managers place their emphasis on outcomes—whether the strategic goals are being achieved. *How* the goals are achieved typically is delegated to the property management company.

Develop and Implement Strategic Plans. The strategic plan is the backbone of asset management strategy. A strategic plan begins with the goals of the development team and the current reality of the property, and continues with a consistent and achievable plan for meeting those goals. A good strategic plan provides the blueprint from which the property manager can build a successful operation.

Manage Risk. All income-producing real estate involves risks. Real estate markets fluctuate, sometimes in ways that dramatically decrease the property's income. Rents and operating costs grow at different rates, sometimes in ways that dramatically decrease the property's cash flow. Financing markets fluctuate, sometimes in ways that expose the property to unwanted additional financing costs. Some properties experience outbreaks of criminal activity. To the extent that these risks can be controlled, expert managers find ways to minimize the property's exposure to risk. To the extent that risks cannot be controlled, expert managers find ways to detect dangers to the property as early as possible. Managers then intervene to minimize the impact on the property.

Pay Attention to Marketing. All properties, even those with well-below-market rents, occupy a niche in a neighborhood real estate market. Expert managers understand their local markets, their competitors, and the role that each property plays in the marketplace. Armed with this knowledge, managers can ensure that the property is well regarded and that the property receives its fair share of customers and revenue.

Manage Information. Many asset managers suffer from data overload and information starvation—they have plenty of raw data but have not been able to:

- identify which information is important;
- identify the key relationships between data elements;
- organize key information in an accessible format; and
- use information to stimulate action.

Successful asset managers, on the other hand, develop methods for tracking a relatively small

ABC Apartments, 45 Units, Middletown, USA Asset Management Summary					
Unit Type	# Units	Rent (Low HOME Rent)	Rent (High HOME Rent)	Resident Paid Utilities	Other Features
1-Bedroom	2	$350		$20	1 Bath
1-Bedroom	8		$450	$20	1 Bath
2-Bedroom	5	$400		$35	2 Bath
2-Bedroom	20		$550	$35	2 Bath
3-Bedroom	2	$450		$45	2.5 Bath
3-Bedroom	8		$650	$45	2.5 Bath
Total	45	$23,400 (gross potential monthly rent)			
Note: HOME rents effective 1/1/99. Utility estimate from Middletown Housing Department effective 10/1/98. Actual rents charged at 1/1/99 average 85 percent of maximum HOME rents. Market study 11/4/98 indicates actual rents are approximately 12 percent below market rent levels.					

Resident Profile:	Transitional homeless families
Description:	Substantial rehabilitation completed August 1998, 3 buildings (3-story walkup), originally constructed 1922. HVAC is central natural gas-fired circulating hot water heat (baseboard radiators), sleeves provided to accommodate resident-owned through-the-wall individual air conditioners, central natural gas-fired hot water heater. Residents pay electricity.
Financial Structure:	HOME Loan/Grant, State Affordable Housing Program Loan/Grant, Low Income Housing Tax Credits, ABC Community Bank 1st Mortgage
1st Mortgage:	$1.0 million / 7.5% / 25 years, self-amortizing, ABC Community Bank targeted housing program.
2nd Mortgage:	State Affordable Housing Program, $500,000 1% interest only, no payments due until 1/1/2005.
3rd Mortgage:	City HOME Program, $500,000 same terms as State AHP loan
Major Issues:	Cash flow is marginal but positive. 6/3/98 Capital Needs Assessment indicates that reserves are adequate.

set of data and for using data trends and relationships as signals for tactical or strategic action. Above is an Asset Management Summary that combines a variety of important information that is relevant to creating an asset management strategy for a property, and for monitoring the success of that strategy.

Develop and Use Early Warning Systems. One vital use of information is to anticipate problems before they occur and, failing that, to detect problems early enough that they can be solved relatively easily and relatively inexpensively. Fortunately, many common problems in rental housing can be anticipated and/or detected early through proper early warning systems. Examples include financial problems due to major repair and replacement needs, physical problems due to predictable aging of building systems, and marketing problems due to changes in the local economy.

Invest for the Future. Successful asset managers are continually on the lookout for opportunities to invest in the property. Typical investment opportunities include:

- Utility-saving investments to reduce operating costs;
- "Curb appeal" investments to improve the property's marketing success;
- Compliance training for property staff to reduce the risk of compliance problems; and,
- Preventive maintenance investments to lengthen the useful lives of major building systems.

Measure Performance. Most business executives believe that "if you can't measure it, you can't manage it." Many public officials and not-for-profit organizations may find this attitude unnecessarily hard-nosed. However, successful asset management—even in affordable rental housing—requires finding ways to measure

ABC Apartments - Key Indicator Report - December 1999

Key Indicator	Standard	Achieved?
Income vs. Budget	>=100%	Yes
Expenses vs. Budget	<=100%	Yes
Rent Collection This Month	>=95%	Yes
Work Orders Completed On Time	>=95%	Yes
Resident Satisfaction	>=95%	Yes
Key Indicator Score		5
		HONOR ROLL!

Middletown Community Housing Development Corporation
Key Indicator Summary
December 1999

Property	Score	Honor Roll?
ABC Apartments	5	Yes
DEF Apartments	5	Yes
GHI Apartments	3	No
JKL Apartments	5	Yes
MNO Apartments	1	No
PQR Apartments	4	No
XYZ Apartments	4	No
Total	7 Properties	3 Honor Roll

Consider weighting the scores a variety of ways based on your priorities, those of the lender, participating jurisdiction, or other principal parties. Other performance measurements might include a particular score on a physical inspection, improvement in collections, capital improvements vs. budget, or any other issues that are relevant to the properties in the portfolio.

success, so that the asset manager can determine objectively whether the property is or is not meeting its strategic goals. Expert managers advise creating a relatively small number of "key indicators" that relate directly to operational success and to the property's strategic objectives, and that will be measured and monitored frequently by asset managers and property managers. Determining key indicators involves difficult challenges such as how to measure resident empowerment, but the use of key indicators allows asset managers to manage professionally and competently, rather than by "gut feeling" or "seat of the pants." See the Sample Key Indicator Report on page 5.

Communicate Expectations. Successful asset managers make sure that their property managers and other partners know what results are expected from the property, where possible tied to specific dates and specific measurable outcomes. "I expect a 90 percent score on the September review" is more likely to lead to success than "Do your best and we'll talk about it this fall." Expert managers integrate concrete expectations into all routine management processes, including the annual budget, periodic property performance reviews, responses to operating and financial reports, and strategic decisions.

Expert asset managers realize that they achieve results not directly, but through the property managers who actually carry out the day-to-day management functions. The following section will discuss the essential responsibilities of the property management company and the factors that produce success in property management. Armed with this knowledge, asset managers will be better able to ensure that the property meets all HOME requirements and the intended strategic objectives.

The Property Management Agreement

The property management company operates the property on a day-to-day basis, under a *property management agreement* with the owner. The property management agreement is one of the primary governing documents for an apartment property. Other important governing documents in affordable rental housing may include:

- The HOME Agreement between the sponsor and the participating jurisdiction;
- The property's mortgage financing documents; and,
- Any deed restriction or similar affordability agreement.

Sponsors are advised to collect all governing documents for each property and to provide copies to key professionals, including asset managers, property managers, and the sponsor's legal, accounting, and tax advisors.

The following provisions typically appear in property management agreements for apartment properties (whether market rate or affordable):

- *Engagement*. The management company is hired to manage the property. Sometimes, the management company is designated as the owner's legal *agent* (a relatively broad form of authority). Sometimes the management company is designated as a *contractor* (a narrower form of authority).
- *Authority*. Typically, the management company is given the exclusive authority to manage the property. In addition, and subject to applicable legal and regulatory requirements, the management company is given authority to advertise dwelling units for rent, to lease dwelling units to residents, to set rental rates, and to enforce leases. The management company is often given authority (with limitations) to enter into contracts in the owner's name.
- *Property Description*. The property is identified by name, address, and number of units. If the property includes non-residential components such as office space, retail space, and public parking, the agreement will include any special provisions for the commercial facilities.
- *Term*. The agreement has a fixed beginning date and usually has a fixed ending date (although some *open-ended* agreements run until cancelled).
- *Property Management Fee*. The management company's compensation is defined. The most common (although by no means universal) fee structure is a percentage of collected revenue. Sometimes the management company can earn supplemental fees for performing specific tasks, such as achieving initial lease-up, managing a capital expenditure program, or implementing an anti-crime program. Fees should reflect the property management difficulty factors. (See page 16)**.**
- *Cash Management*. The agreement will describe each of the bank accounts that the

owner requires management to maintain, as well as:

– Owner requirements for selection of banks;

– Owner requirements for maximum or minimum account balances;

– Whether each account is interest-bearing, and, if so, how the interest earnings will be handled;

– Owner requirements for a fidelity bond to protect the owner against misappropriation of funds by management personnel;

– Types of deposits and disbursements to be made to and from each bank account. This section would include any owner requirements regarding which bills are to be paid first;

– When and how the property's cash flow is to be distributed to the owner; and

– The procedures that management will follow if operating funds are not sufficient to cover expenses.

- *Front Line Staff*. The management company's responsibilities for hiring, supervising, and disciplining the site manager, maintenance staff, and other *front line* staff are defined. Front-line staff are sometimes referred to as *site-level* staff or *on-site* staff. Sometimes, front-line staff are employees of the owner but supervised by the management company. Increasingly, however, front line staff are employees of the management company (with all employment costs reimbursed by the property) because this approach facilitates the creation of competitive benefit packages and other features that help attract and retain top quality front-line staff. The agreement will also discuss whether any staff will reside at the property, and, if so, on what terms. This section of the agreement also specifies procedures for payment of applicable payroll taxes, workers compensation insurance, health insurance, and other employment benefits.

- *On-Site Management Facilities*. The agreement will specify what facilities within the property are available for management use. Although some properties have no management facilities on-site, typical facilities include an on-site office (which may be a converted residential unit) and a maintenance shop.

- *Management Company Costs*. The agreement describes which costs are expenses of the management company. Typically, the management company must bear the following costs:

  – All employment costs for the *non-front line* staff of the management company (also sometimes called *off-site* staff or *supervisory* staff). These staff positions include the *property supervisor* (or *district manager* or *property manager*) who oversees this and several other properties, the management company's accounting staff, the management company's human resources staff, and the management company's executives and executive support staff.

  – Office and travel costs for non-front line staff.

- *Property Costs*. The agreement describes which costs are expenses of the property. Typically, the property bears all costs of operation not specified as management company costs. Sophisticated agreements clarify who will bear a number of costs that sometimes result in disagreements between owners and agents:

  – Which accounting tasks will be performed at the property's expense and which will be performed at the expense of the management company.

  – Recruiting and training costs for front line staff.

  – Where the front line staff are employees of the management company, costs of defending employment-related lawsuits.

  – Financial losses due to regulatory compliance errors by front line staff.

  – Whether volume purchasing discounts, discounts for early payment, rebates, and commissions are to be credited to the property. Similarly, whether late payment penalties are to be paid by the property or sustained by the management company.

  – Postage and delivery charges, for items mailed or shipped from the management company to the property, and from the property to the management company.

  – Long distance charges for calls between the property and the management company.

  – The cost of defending fair housing, employment, and environmental complaints.

- *Budgets.* Typical agreements require the management company to submit a proposed budget to the owner one to three months prior to the start of the fiscal year. The owner agrees to approve the budget (as is or with modifications) promptly. The management company agrees to operate the property in reasonable compliance with the budget. Agreements vary regarding the degree to which the management company can exceed the budget without owner approval, although most agreements require owner approval only for expenditures that would put the property materially over budget in an entire cost category.

- *Insurance.* Property insurance is always an expense of the property (typically paid by the mortgage company and collected from the property in monthly installments as part of the mortgage payment) but not always purchased and maintained by the management company. Typical agreements specify what types of insurance will be maintained, the levels of coverage to be maintained, name the owner and management company as insured parties, and indicate that the management company will promptly notify the owner of any event that might lead to an insurance claim.

- *Real Estate Taxes.* The agreement will specify who will review, approve, and (where necessary) protest real estate tax assessments. If the property has a real estate tax abatement or payment in lieu of taxes (PILOT) agreement, the property management agreement will include any management company duties with respect to maintaining the abatement or complying with the PILOT agreement.

- *Regulatory Compliance.* Typically, the management company is responsible for compliance with all applicable governmental requirements. The owner and management company will agree on the division of responsibility for compliance with HOME requirements. These include setting rents, establishing lease terms, resident selection, and income certification and recertification. Typically, the management company must promptly notify the owner of any compliance problem. (See Chapter 3.)

- *Property Records.* In most cases, the property's financial and operational records belong to the owner and must be delivered to the owner at the end of the property management agreement's term. The management agreement will specify who will maintain the records required by the HOME Program. If it is the management company, it must agree to maintain a system of records sufficient for the participating jurisdiction and/or HUD to verify compliance. (See 24CFR §92.508(a)(3).)

- *Indemnification.* Typically, the owner agrees to hold the management company harmless with respect to events occurring at the property, except in the event of fraud or gross negligence of the management company. Similarly, the management company agrees to hold the owner harmless if the management company acts fraudulently, is grossly negligent, or exceeds its authority under the property management agreement.

- *Termination.* Most agreements include provisions allowing for one party to terminate the agreement in the event of serious disagreement, or in the event of serious nonperformance by the other party. Often, in affordable rental housing, a regulatory agency or lender will have the right to terminate the property management agreement as well. Experienced owners and managers have learned that vague termination provisions produce more problems than they solve. Accordingly, both parties typically want the termination provisions to be as explicit and objective as possible. Typically, the property management agreement automatically terminates upon sale of the property or upon a foreclosure.

Some of the additional HOME requirements that may affect the property management agreement include:

- *Subsidy Layering Review.* This is a review to ensure that Federal subsidies (including HOME funding) do not exceed requirements.

- *Matching Requirements.* If the property has a real estate tax abatement agreement, the abatement may have been counted toward the participating jurisdiction's matching-funds requirement under HOME. If so, the participating jurisdiction may require that the property management company accept responsibility for maintaining the property's eligibility for the abatement. Also, the management company may be required to document the amount of the abatement over time. If a property is providing supportive services to the tenants living in HOME-assisted units, the cost of the service may also be applied towards match during the affordability period. The participating jurisdiction may request

reports and records for costs associated with these services when funded with non-federal funds, which may include case management, mental health services, assistance with the tasks of daily living, substance abuse treatment and counseling, day care, job training, and counseling. (See 24CFR §92.220(a)(10).)

The property management agreement is the management company's marching orders. Management companies can follow very different paths to implement these marching orders, depending on company structure, company philosophy, and personnel. However, top-flight property management companies (like top-flight asset managers) typically display a relatively small number of essential characteristics that differentiate them from average or below-average companies.

The Essentials of Property Management

There are three characteristics that are present in all excellent property management companies:

- **Professional Management** – The management of affordable rental housing requires more than a commitment to affordability. Its complexity demands certain expertise. Successful property management requires the competence, commitment, systems, and continuous learning that come from a property management organization's institutional dedication to its business, and from individual managers' dedication to their careers. In affordable rental housing, successful property management also requires a commitment to the specialized skills required to meet the sponsors' affordability objectives. Residents, community members, and volunteers can be part of a successful property management operation, provided that they acquire the necessary skills, information, and experience to become professionals themselves.

- **Top Quality Front Line Staff** – Of all the forms of income-producing real estate, apartments are the most sensitive to the quality of the site-level staff. By signing a lease, a resident is purchasing a service package along with four walls and some doors and windows and the service package is delivered by the site-level staff. Many well-designed, attractive properties have achieved sub-par results because the on-site staff was ill-prepared, insufficiently attentive to the needs of applicants and residents, or simply mismatched with their jobs. On the other hand, many properties with small units, below-average design, and secondary locations achieve outstanding results because their on-site staff are properly trained, properly supported, and fully committed to delivering outstanding service to applicants and residents.

- **Sophisticated Budgets** – The best property management companies invariably use very advanced property budgets. The budget package is easy to understand; it includes summary reports (see the example on the following page) as well as detailed schedules, and it includes notes that explain how amounts were calculated. It compares the budget year to historical actual results. In many instances, the budget will include multi-year projections as part of the property management company's early warning system. The budget package will include a multi-year capital expenditure plan. The budget process includes a review of the multi-year strategic plan to determine if strategy needs to change. Most importantly, the property's monthly results are compared carefully to the budget with the result that the property's results become more and more predictable and consistent the longer the property management company is in place.

Top-flight property management companies will be experts in a number of essential task areas.

In addition to the preceding three essentials, top-flight property management companies will be experts in a number of essential task areas.

Property management is a multi-faceted task. Successful property management firms have to be "jacks of all trades" in order to be able to manage all aspects of a property's day-to-day operations. The successful property management of affordable rental housing is even more complicated because it entails a host of compliance issues, plus specialized skills as required by each property's target resident population. The following discussion will highlight a few of the main tasks required for successful property management.

Sample Summary Budget Report

FGH Apartments - Middletown, USA - 50 Units

Budget Category	1996 Actual	1997 Actual	1998 Actual	1999 Estimate	2000 Budget	2001 Forecast	2002 Forecast	2003 Forecast	2004 Forecast
Gross Potential Income	$375,188	$387,254	$398,188	$395,862	$407,700	$419,900	$432,500	$445,500	$458,900
Rent Loss	-19,521	-26,100	-25,243	-17,061	-17,600	-18,100	-18,600	-19,200	-19,800
Other Income	6,593	6,975	9,771	7,206	7,400	7,600	7,800	8,000	8,200
Effective Gross Income	$362,260	$368,129	$382,716	$386,007	$397,500	$409,400	$421,700	$434,300	$447,300
Marketing Expenses	5,939	5,275	6,081	5,225	5,400	5,600	5,800	6,000	6,200
Payroll Expenses	16,519	19,114	15,311	16,140	16,800	17,500	18,200	18,900	19,700
Property Management Fee	14,858	13,144	13,756	13,627	14,200	14,800	15,400	16,000	16,600
Other Administrative	3,780	3,366	2,981	3,453	3,600	3,700	3,800	4,000	4,200
Utility Costs	16,553	18,295	19,726	18,605	19,300	20,100	20,900	21,700	22,600
Non-Housing Services	7,524	7,783	8,523	8,898	9,300	9,700	10,100	10,500	10,900
Protection Costs	2,456	2,756	2,974	2,890	3,000	3,100	3,200	3,300	3,400
Normal Repairs	32,192	27,618	31,774	29,630	30,800	32,000	33,300	34,600	36,000
Real Estate Taxes	32,847	40,159	38,142	34,007	35,400	36,800	38,300	39,800	41,400
Property Insurance	3,602	4,019	3,650	3,349	3,500	3,600	3,700	3,800	4,000
Capital Expenditures	38,934	14,276	18,273	18,793	19,500	20,300	21,100	21,900	22,800
Total Expenses	$175,204	$155,805	$161,191	$154,617	$160,800	$167,200	$173,800	$180,500	$187,800
Net Operating Income	$187,056	$212,324	$221,525	$231,390	$236,700	$242,200	$247,900	$253,800	$259,500
Debt Service	195,570	195,570	195,570	195,570	195,570	195,570	195,570	195,570	195,570
Asset Management Costs	10,000	10,400	10,800	11,200	11,600	12,100	12,600	13,100	13,600
Cash Flow	-$18,514	$6,354	$15,155	$24,620	$29,530	$34,530	$39,730	$45,130	$50,330

Marketing

Every apartment property (even one with 100 percent deep subsidy, whose residents pay rents that are several hundred dollars below market levels) involves marketing. Marketing issues include:

- identifying potential residents;
- communicating essential information about the property to potential residents, including developing and implementing an Affirmative Fair Housing Marketing Plan for HOME-assisted properties with five or more units (see 24CFR §92.351);
- making the property attractive to potential residents;
- converting inquiries into applications;
- converting applications into move-ins; and
- retaining existing residents.

Of course, marketing issues are more vital for properties with rents at market or close to market, by comparison to properties with rents that are well below market. However, there is no property for which marketing can be ignored.

Resident selection criteria, and their application by the property manager, are critical factors in the success of the property.

Rent Setting

In a market-rate apartment property, the property manager's expertise in setting rents is a major contributor to the property's success. The property manager must determine the features, services, and rents that appeal to residents and potential residents, and must continually adjust prices (rents) in response to market trends. In an affordable apartment property, rent-setting can be just as important. The HOME Program sets limits on rents for units assisted with HOME funds, called High and Low HOME Rents (see Chapter 3), with significant penalties if those limits are exceeded. Properties can contain both HOME-assisted and market-rate units, and units assisted by other public programs. Other programs often involve complicated processes for determining and approving rent levels. Often, it is necessary for property managers to anticipate major costs several years in advance, in order to set rents so that these costs can be accommodated within the rent limits applicable to the property. Successful property managers always pay close attention to rents, to make sure that rents are always set at the correct level.

Resident Selection

Apartment owners and managers develop *resident selection criteria* that property managers use in making decisions whether to accept or decline rental applications. The development of the criteria, and their application by the property manager, are critical factors in the success of the property. The importance of resident selection is demonstrated by the experience of long-time managers:

- A single disruptive household can produce interpersonal and financial disaster at an apartment property. One bad household can result in a wave of move-outs and a drop in applications as well. This is equally true in affordable and market-rate properties.
- A large proportion of rent that is not paid in full and on time is never collected. (This is even more true for affordable properties than for market-rate properties).
- Overly restrictive criteria will produce inadequate occupancy levels (and thus inadequate rental income to operate the property).

Accordingly, owners and managers develop resident selection criteria that balance the property's need for high occupancy levels with the need to minimize the risk of disruptive and/or non-rent-paying residents. Expert managers routinely decline applications from households with histories of disruptive personal conduct that would violate the lease because the risks are so great. Expert managers are more divided on the question of whether to accept applicants with borderline rent payment history or borderline credit history. However, managers who are willing to accept high-credit-risk applicants combine their more lenient selection policy with a very tough rent collection policy. The combination of lenient resident selection and lenient lease enforcement is shunned by expert managers.

Typical resident selection criteria relate to these four areas:

- **Income** – Applicants under consideration for a HOME-assisted unit must have gross household incomes at or below 80 percent of the area median, adjusted for household size. In properties with 5 or more HOME-assisted units, at least 20 percent of the tenants must have gross incomes at or below 50 percent of

median, although in many properties this percentage is likely to be much higher. (See 24CFR §92.252.) These households will be charged Low HOME Rents. In a property with both High and Low HOME Rent units, the rent level of the available unit will determine the maximum income of the household that can be selected to occupy it. The HOME Program has specific rules for determining household income (see Chapter 3).

Whatever the rent level, applicants must have sufficient income to give reasonable assurance that the household can afford the rent. This can be as simple as a requirement that applicants have monthly income that is at least a specified multiple of the rent. The policy can also include consideration of mitigating circumstances, such as a low debt burden (thereby making more of the household's income available to pay rent) or a history of paying similar rents reliably (thereby indicating that the household can manage an above-normal rent burden). The rental application form will require the applicant to specify the household's income. Management will verify the income information.

- **Housing History** – Evidence to support a reasonable presumption that the household will avoid undue wear and tear on the apartment, respect the rights of other residents, and otherwise abide by the lease. The rental application will request the address and landlord contact information for the applicant's current residence. Typical applications also request this information for one or more previous residences as well. Management will contact the landlord(s) and obtain a *landlord reference* including beginning and ending dates of occupancy, rental rate, whether rent was consistently paid on time and in full, and whether the household violated any lease provisions. Some properties' resident selection policies require a *home visit* to the applicant's current residence to verify that the applicant can be expected to honor lease requirements regarding housekeeping and avoiding damage to the property.

- **Credit History** – Evidence to support a reasonable presumption that the household will pay the rent. Many management companies request a *credit report* for all applicant households. Some management companies request a credit report only for households who have no rental housing history.

- **Criminal Record** – Evidence to support a reasonable presumption that the household will refrain from criminal activity.

- **HOME Tenant Selection Requirements** – Although the above-mentioned points are very important to managing a successful rental property it is also critical for apartment owners and managers with HOME-assisted units to be aware of the HOME requirements for tenant selection found at 24CFR §92.253(d). Owners should adopt *written tenant selection policies and procedures* that:
  - Are consistent with the purpose of providing housing for very low- and low-income families;
  - Are reasonably related to program eligibility and the applicant's ability to perform the obligations of the lease;
  - Provide for the selection of tenants from a written waiting list in the chronological order of their applications, insofar as is practical; and
  - Give prompt written notification to any rejected applicant of the grounds for the rejection.

Compliance with fair housing laws requires that resident selection criteria be directly related to lease compliance and must be applied consistently to all applicants. Sponsors should consult with their legal and property management advisors regarding development of the property's resident selection criteria, rental application form, occupancy and admissions policies, and waiting list policies. In particular, these materials should be reviewed carefully for compliance with non-discrimination requirements protecting persons with disabilities.

Some governmental officials and not-for-profit organizations may find the notion of resident selection inconsistent with their understanding of the affordable housing mission. However, rigorous resident selection is a consistent feature of well-managed public housing and well-managed not-for-profit housing demonstrating that management experts do not restrict resident selection criteria to for-profit housing. Property management experts agree that a property that does not exercise effective resident selection is a property that will soon be in trouble. Resident selection is particularly important at the time of initial lease-up; poor choices at this crucial time can damage a property for years.

Lease Enforcement

The HOME Program requires a lease term of at least one year unless by mutual agreement of the tenant and owner (see 24 CFR §92.253(a)). The HOME Program permits lease termination only for "serious or repeated violation" of the lease, and requires at least 30 days advance written notice to the resident prior to termination of tenancy. (See 24 CFR §92.253(c).)

The HOME Program regulations include a list of prohibited lease provisions at 24 CFR §92.253(b).

Sponsors should ensure that their lease facilitates HOME compliance. For example, the lease should allow the participating jurisdiction to make inspections. Similarly, the lease should advise residents of the requirement for income recertification and require that residents cooperate in this process. Without the ability to verify or have the resident certify income, the resident may face paying market rents.

Sponsors should consult their legal and property management advisors regarding development of each property's standard lease, taking into account applicable landlord-tenant laws, standard leases that are used widely by local owners, and the requirements of HOME and any other governmental programs in effect at the property.

Despite conscientious resident selection practices, some households will violate the lease. In some cases, a model resident develops problems due to a lapse in income, drug abuse, alcohol abuse, or other stresses. Sometimes, a borderline (but acceptable) applicant turns out to be a problem resident (probably far outweighed by other borderline applicants who became model residents). Whatever the reason, once the lease is violated, the experience of expert managers is that either management must enforce compliance or other residents will begin violating the lease, too. Lease enforcement is unpleasant and thankless work, but it is necessary if the integrity of the community is to be maintained. Successful property managers take a deep breath and begin effective enforcement action; unsuccessful property managers procrastinate or take tentative steps that are not sufficient to induce lease compliance.

Another lesson from expert managers is "no pay, no stay." This is a tough stance that demands that the rent be paid (and institutes eviction proceedings when rent is not paid). Many government officials and not-for-profit professionals (as well as many first-time property managers) may believe that this approach is far too hard-nosed. However, experienced managers point out the drawbacks of "working with the resident":

- If the resident can't pay one month's rent now, how will the resident pay two months' rent less than 30 days from now?
- Lax collections send a message of lax management to the residents. If residents see that rent collection is loosely enforced, they will assume the rest of the property rules are loosely enforced.
- If you give one resident two weeks extra to pay rent this month, ten residents will ask for two weeks extra to pay next month's rent.

One important lease enforcement principle is to distinguish between minor and major violations of the lease. A single major violation (for example, failure to pay rent or assaulting a neighbor) is sufficient to result in lease termination. Minor violations (one month's rent paid late, playing loud music late at night) result in warnings, and typically lease termination would not result unless there are multiple minor violations or repeated minor violations.

Experienced managers also recommend great care in communication and documentation. Residents who violate the lease should be made aware of the violations, how to cure them, and the consequences of repeat violations. This communication should be clear and unambiguous. It should come promptly after management becomes aware of the violation. It should be in writing (ideally, verbal with written confirmation). It should give enough detail for the household to understand exactly what the problem is and exactly what to do about it. Regarding documentation, management should collect evidence of the violation, including (where applicable) photographs, inspection reports, affidavits from staff, police reports, and statements from witnesses.

Affirmative Marketing

An owner or manager should be aware of the affirmative marketing requirements of the HOME regulations. Owners should attempt to attract eligible persons in the housing market area without regard to race, color, national origin, sex, religion, familial status, or disability. See Chapter 3 for additional information.

Maintenance
As with all HOME-assisted properties, rental properties must meet certain written standards for acquisition, construction, rehabilitation, and accessibility. See Chapter 3 for a discussion on maintenance property standards. The physical upkeep of the property is one of management's major tasks. Some of us may have an image of maintenance technicians rushing around, responding instantly to service requests from residents. However, expert property managers approach maintenance in a very different manner:

- Apartments are prepared to very high levels of quality at the time of move-in. By demonstrating management's commitment to uphold its obligations under the lease agreement, management encourages new residents to uphold their lease obligations as well.
- Management periodically inspects apartments, using a standard written checklist. When repairs are needed, management generates written work orders that are then completed promptly and competently. This process not only produces well-maintained housing, but also maintains a valuable written record.
- Whenever the maintenance staff visit an apartment, they check for problems like plumbing leaks, non-functioning smoke detectors, and clogged furnace filters.
- As components approach the end of their useful lives, management stocks a sufficient quantity of replacements so that downtime is minimized when a component fails.
- Of course, when residents do call with service requests, those requests are completed promptly and competently.
- Expert managers distinguish between emergency service requests (which are handled immediately), and routine requests (which are generally handled within 1-3 days, depending on the efficiency of the operation). Expert managers also track the time it takes to complete all requests for maintenance service as this is an important measure of resident satisfaction and operations quality.

The preceding approach can be characterized as "management managing the maintenance function." The "rushing around" approach can be characterized as "the maintenance function managing the management company." Expert managers stress the importance of good documentation of the maintenance process: written inspection forms and checklists, written work orders, and notations of work completed. This documentation allows management to verify compliance with maintenance requirements (such as those imposed by the HOME Program) and generally helps minimize disputes and misunderstandings regarding maintenance activities.

Capital Expenditures
Expert property management companies develop special expertise in major purchases that occur regularly in apartment management, such as roof replacements, wholesale appliance replacements, exterior painting, parking lot resurfacing, and replacement of carpets and floor tile. Although price is always important, intelligent purchasing involves many additional considerations, including quality of materials, quality of installation, quality of warranty, timeliness, and whether delivery/installation/setup are included. Price considerations include whether discounts are available for early payment (and, conversely, whether payment can be spread out over time).

Regulatory Compliance
All apartment properties involve significant levels of regulatory compliance including:

- Building and housing codes;
- Landlord-tenant law;
- Fair housing laws;
- Environmental regulation (asbestos, lead-based paint, underground fuel storage tanks, CFC's, radon, etc.); and
- Wage and hour regulations.

Properties receiving HOME assistance must comply with the HOME Program's regulatory requirements. The HOME regulatory requirements cover rent setting, resident eligibility, and the physical condition of the property and its apartments. (See Chapter 3).

In addition to the HOME regulatory requirements, affordable rental housing may involve significant additional regulation relating to the various affordability programs, including:

- Subsidy programs, such as HUD's Section 8 Program and state/local tenant-based assistance programs;
- Mortgage finance programs, such as a state affordable housing trust fund that provides below-market-interest-rate loans; and,

- “Gap” funding programs, such as the Low Income Housing Tax Credit.

Each such program will impose its own set of compliance requirements. Expert managers develop and maintain comprehensive systems for achieving high levels of regulatory compliance. Typically, these systems include procedures, checklists, reports, training, inspections, and reviews.

Financial Management

The property management company collects all property revenue, pays all property expenses, segregates the funds of each property, makes required payments on property debt, and makes permissible cash flow distributions to the property’s equity providers. Most properties have several cash and investment accounts, each of which must be managed to a different set of requirements. The management agent maintains residents’ security deposit funds in accordance with applicable state and local law. These are complicated tasks, requiring a great deal of care plus good documentation. Expert management companies have strong financial management processes, including computerized accounting systems, plus sophisticated procedures designed to prevent errors and to detect those errors that do occur.

Financial Reporting

Typically, the management company reports to each property owner at least monthly. The monthly reporting package:

- Details all financial transactions;
- Summarizes monthly and year-to-date activity according to meaningful reporting categories; and
- Compares actual results to budgeted results.

Often, the package includes other information that owners have found helpful (such as information on cash and investment account balances, outstanding accounts payable, and outstanding accounts receivable).

Fair Housing

Expert property managers must have detailed knowledge of fair housing requirements plus effective systems for achieving fair housing compliance. Like all apartments, properties financed under the HOME Program are subject to standard fair housing requirements prohibiting discrimination based on race, color, religion, sex, national origin, familial status, and disability. Properties financed under HOME face additional requirements:

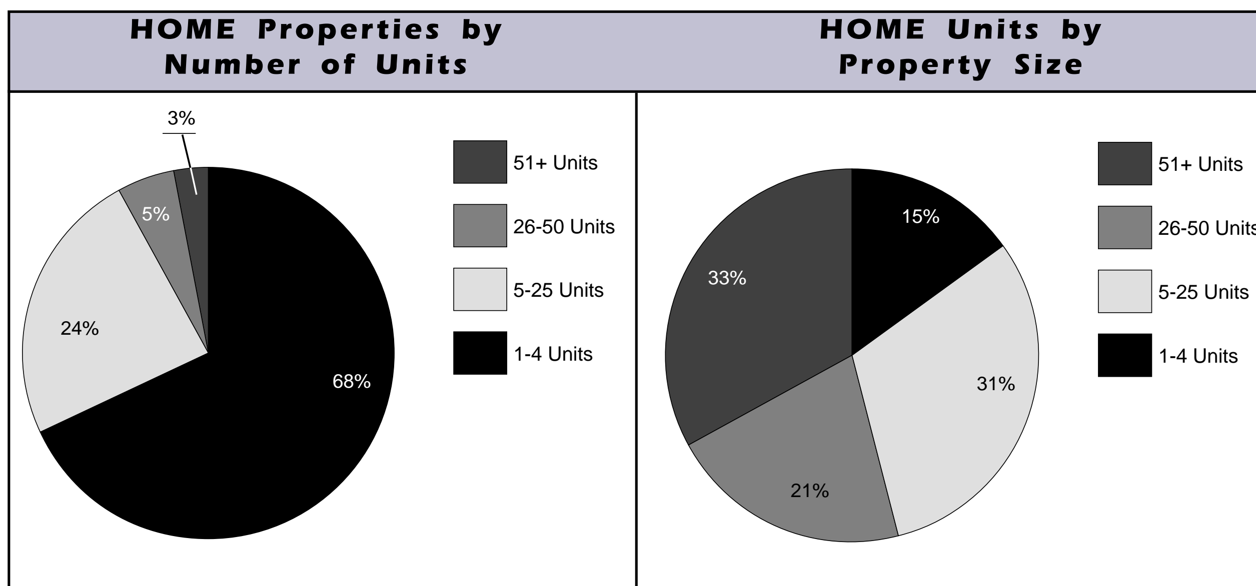
- **Section 504** – All properties financed under the HOME Program are subject to Section 504 of the Rehabilitation Act of 1973, which requires that property owners make certain procedural and/or structural modifications to allow persons with disabilities to access and use the property and services.
- **ADA Title II** – Properties owned by state or local government entities are subject to Title II of the Americans With Disabilities Act, which imposes requirements similar to those under Section 504.
- **State and Local Fair Housing Laws** – Many states and localities have enacted fair housing laws that impose requirements in addition to those of Federal fair housing laws. Some state and local laws create additional *protected classes* (for example, prohibiting discrimination based on source of income, marital status, or sexual orientation); and some state and local laws impose additional requirements concerning the federally protected classes.
- **Affirmative Fair Housing Marketing Plan** – HUD requires sponsors to obtain participating jurisdiction approval of an outreach plan for properties with five or more HOME-assisted units to ensure that all groups, including those “least likely to apply,” have an opportunity to receive marketing information about the property. See Chapter 3.
- **CHDO Tenant Participation Plan** – Community housing development organizations (CHDOs) that receive property-specific HOME assistance must adhere to a fair lease and grievance procedure and must facilitate tenant participation in management decisions (24 CFR §92.303).

Managing the Very Small Property

Standard practices in the apartment industry were developed primarily for properties of 100 units or more. However, most affordable rental housing properties developed with HOME funds are substantially smaller.

A number of operational issues are specific to properties of 50-60 units or less. These issues

The graphs below reflect rental housing properties financed through HOME and completed through September 30, 1998, by size of property. Although most properties were 1-4 units, most of the HOME-financed units were in larger properties.



revolve around how to deliver front line staff functions. In market rate garden-style apartments, typical front line staffing is one administrative person and one maintenance person for every 75 to 100 units. Thus, a property of less than 75 units faces a staffing problem. Experienced managers look for one of the following solutions:

- **Part-time staff** – For example, a 40-unit property might have a half-time manager and a half-time maintenance person.
- **Shared staff** – For example, two 40-unit properties might share a full-time manager and a full-time maintenance person.
- **Combination staff** – For example, a 40-unit property might be staffed by one full-time person who combines administrative and maintenance duties. This solution is rare.
- **Off-site staff** – For example, an eight-unit property might have no on-site staff. The front line manager and front line maintenance staff would visit the property, as needed.

Accordingly, sponsors of small properties look for property management companies with other properties in the immediate neighborhood and with a track record of solving these types of staffing problems for similar properties.

Small property size is a specific example of a larger phenomenon: factors that influence difficulty of management. Experienced owners and managers recognize that properties vary widely in difficulty, and that it is vital to recognize these difficulty factors at the time a property is planned.

Property Management Difficulty Factors

To outsiders, it may appear that all apartment properties are essentially the same and that a property management company (or property manager) who is successful at one property should be successful at any other property. Unfortunately, the real world is more complicated. Like Olympic skating or diving routines, apartment properties vary greatly in their "degree of difficulty." Some of the relevant factors include:

- **Resident turnover rate** – Other things being equal, a property with high resident turnover is more difficult to manage than a property with low resident turnover. A turnover rate of 50 percent means that the property typically experiences 50 move-outs per 100 apartments per year. The owner or manager must have a strategy for affirmatively marketing vacant HOME-assisted units as resident turnover occurs.

- **Over-income residents –** The HOME regulations have specific guidelines on what to do when residents' incomes have increased beyond the income limits during their tenancy. See Chapter 3 for more information.

- **Financial health** – Other things being equal, a property with adequate financial resources is much easier to manage than a property that is under financial stress. Properties under severe financial stress are significantly more difficult to manage.

- **Property age** – At new properties, everything is new and attractive, everything works, and nothing is wearing out—a very forgiving situation. At older properties, marketing and leasing are more difficult because of older-generation kitchen and bathroom fixtures. Older building systems need major repair and replacement which require considerable time and expertise from the property management staff.

- **Level of crime** – Most properties have average or below-average rates of crime. A property with well-above-average crime rates demands greatly increased attention from its property managers and asset managers to design and implement the needed anti-crime initiatives.

- **New construction vs. rehabilitated properties** – Other things being equal, properties that were newly constructed are easier to manage than properties that were rehabilitated. The rehabilitated properties are more likely to face unusual problems related to the age of the buildings (such as failure of in-the-wall or underground utility pipes, expiration of very long-lived components such as elevators and central boilers, lead-based paint, or asbestos). Finally, the reality of rehabilitated properties is that many received less rehabilitation than they really needed, introducing a host of additional "difficulty factors."

- **Physical health** – Properties that experience frequent breakdown of major building systems are dramatically more difficult to manage than properties that are physically stable.

- **Location –** At the easy end of the spectrum is the property in an attractive location, with good access to shopping/jobs/recreation, good drive-by visibility, strong population growth, low noise levels, low levels of environmental pollution, and low crime. At the other end is the property with the opposite set of attributes.

- **Service enrichment** – Properties serving a welfare-to-work clientele often require extensive non-housing services to support families' attempts to become economically self-supporting. Properties serving transitional homeless populations or persons with AIDS typically include very significant service components. The service package requires significant management effort.

- **Non-Standard Governance** – Many affordable properties use a complex governance structure with significant participation by residents and community members in day-to-day decision-making. By comparison to governance structures that are typical for market-rate apartments, these governance structures place additional workload requirements on the property management team.

- **Proximity to the management company's office** – Experience shows that properties located more than about two hours' drive time from the management office are much more difficult to manage and much more likely to develop problems.

- **Proximity to other managed properties** – Other things being equal, a property that is close to other properties managed by the same company will be easier to manage and will perform better.

- **Single-site versus scattered-site** – Properties that are located on a single site are much easier to monitor than properties on scattered sites. Scattered-site properties are particularly difficult for the maintenance staff—who sometimes find themselves far from the maintenance shop but needing a critical part or tool.

- **Very small properties** – Properties too small to afford full-time front-line staff are significantly more difficult to manage than properties that can utilize more standard staffing patterns.

- **Very large properties** – Properties of 500 units or more introduce additional challenges as well. These properties require a very large staff, introducing communication challenges that are not faced by smaller properties. For example, just keeping track of which units are vacant and which are rent-ready becomes non-trivial.

- **Number of units** – Although the number of units is a good yardstick for the workload of the on-site staff, it is a relatively weak yardstick for measuring the workload of the supervisory staff who are off-site. Expert managers would argue that each of the factors previously mentioned makes more difference to the off-site supervisory staff than number of units.
- **Understanding "floating" and "fixed" units –** HOME-assisted units are designated as either "floating" or "fixed" before project completion. When the HOME rents and occupancy requirements apply to certain specific units for the duration of the affordability period, these units are called "fixed" units. "Floating" units do not have to be the same physical units throughout the period of affordability, but the number of HOME-assisted units must remain the same throughout the affordability period. For a full discussion on "fixed" and "floating" units, see Chapter 3.

Property difficulty factors vary widely. A particularly challenging property may require as much management effort as two or more properties of average difficulty.

Difficulty factors are important considerations in selecting a property management company. There are, however, a number of other important considerations as well.

Selecting a Property Management Company

Typically, the owner's asset manager selects the property management company. Finding the right firm for the job isn't always easy. Experienced asset managers, however, have learned some valuable lessons about the selection process that lead not only to the right management agent, but also establish the groundwork for an effective relationship. In addition to these, it is important for the selected firm to have a general understanding of the HOME Program, as well as to know how to communicate with the participating jurisdiction if the need to clarify regulations or ask questions arises.

A good RFP process leads not only to the right management agent, but also sets the groundwork for an effective relationship.

Identity of Interest vs. Fee Management Companies

Some owners create an affiliated property management company (identity of interest) that manages most or all of the owner's portfolio; this practice is particularly common for owners with large portfolios. One advantage of an *identity of interest* property management company is that knowledge gained in the property management business can enhance the owner's ability to design and develop successful new properties. Another advantage is greater familiarity with the portfolio. On the other hand, many owners have discovered that becoming expert at development *and* property management is a much more challenging task than becoming expert only at development. Accordingly, many owners (even some large ones) rely exclusively on *fee managers*. Also, even owners with identity of interest property management companies sometimes seek third party property management for properties outside their affiliated management company's geographic coverage and for properties needing expertise that their affiliated company does not yet possess.

Request for Proposals (RFP)

A formal request for proposal process forces the asset manager to think about the needs of the property and the possible qualifications of a successful property management company. It also ensures that these issues are plainly communicated to interested parties. A good RFP sets forth the management issues and challenges. An asset manager doesn't want the property manager to express surprise at the scope of work—after assuming management. Instead, the asset manager wants them to begin the job fully informed and ready to tackle the tough issues. The RFP also allows the asset manager to collect all of the information to make an intelligent decision and to make assessments about the comparative strengths and weaknesses of the competitors. Think of the process as similar to hiring a new employee. Advertising, describing the position, and detailing its requirements are all part of the process. Interested parties would send in their resumes, which would be reviewed in light of the needs. The best candidates would be selected for an interview and real negotiations would be

conducted only with the most qualified applicant. Although more work is required by both parties, the RFP process is essentially the same.

How Should the Process be Structured?
Experienced asset managers advise using a multi-step process:

- Determine the criteria to be used for deciding which firm's proposal to accept;
- Collect proposals from interested property management companies;
- Narrow the selection down to a few finalists; and
- Conduct face-to-face interviews with the finalists, preferably in conjunction with a visit to one or more of the properties.

If negotiations with selected property management companies will be conducted after they submit their proposals, include this information in the RFP.

What Information Should be Provided?
A good RFP not only seeks information, but provides it as well. The clearer it is about challenges, needs, and expectations, the more likely the right manager will be identified.

- **Portfolio description** – All relevant aspects of the portfolio should be included. Consider using a chart to represent the portfolio and include for each property: address, buildings, construction type, units, bedrooms, current occupancy and collections, regulatory requirements (such as income restrictions), dates of construction or substantial rehabilitation, and other relevant information. If greater detail would be helpful, include a fact sheet on each property. Consider including photographs.
- **Key issues** – The RFP should spell out the overall issues faced by the portfolio, including the extent of crime, HOME regulatory compliance, social services, deferred maintenance, income and expense issues, and other difficulty factors that would characterize the scope of work. This section can take the form of a short narrative supported by relevant facts and details.
- **Criteria** – Summarize the requirements for a manager (size of operation, types of experience, resources, and capabilities). Enumerate between five and ten criteria to provide potential agents with a sense of the expectations. Distinguish between requirements and preferences. Requirements might include the necessary business licenses (and other regulatory qualifications), minimum experience with HOME or other programs, or property turnaround experience, depending on the needs of the property.
- **Property tour** – Conduct an organized tour of the properties so prospective management agents can assess the issues and make a worthwhile proposal. Specify the time and place.
- **Timeline** – Provide a timeline, including the deadline for submission, and the estimated date that the selection will be made.

Information to Ask for
In addition to providing relevant information, asking the right questions will lead to informative answers. Provide enough of a framework to ensure the necessary information is provided, but also allow enough freedom in the responses to get unexpected answers as well.

- **Basic information** – Request information on the firm's size, number of years in business, types of properties managed, and basic contact information.
- **Key Employees** – Request information on the key employees (firm principals and staff) who will be responsible for managing the properties. Ask for specific accomplishments, particularly as they relate to the issues the property faces. Ask for resumes. Ask for an organizational chart. Ask which employees will be charged to the property, and which will be covered under the management fee.
- **Management approach** – Seek information on operations. How does the agent ensure that the properties are well maintained, that paperwork is in good order, and that applicable laws and regulations are followed?
- **References** – The ideal reference is a customer (property owner) who is not affiliated with the management company or its principals and who has similar properties.
- **Management fee** – Ask competitors to propose the management fee. Typically, property management companies propose either a flat rate (per unit per month), or a percentage fee (of gross rents, collected rents or net rents). Competitors should specify what services the fee covers (in addition to the management fee, some management agents charge separate fees for accounting or payroll management). Depending on the needs of the

portfolio, consider performance-based incentives that would reward the accomplishment of specific goals. The criteria for these types of incentives should be spelled out precisely to avoid future misunderstandings.

- **Insights into the portfolio** – Request ideas for improving portfolio performance. Not only will this help identify the most creative and talented companies, but the best answers can be applied to the operation of the property.

Managing the Process

With foresight and organization, the process will be fair, and the information each party provides will be useful and comparable to others. Control of information is the hallmark of a well-managed RFP process.

- Keep a list of all parties to whom the RFP has been issued. Include e-mail, fax, phone, street address, and a contact name for each.
- Require that all questions regarding the RFP be put in writing. Issue a written response to all parties. This ensures that all parties have equivalent information at all times and, consequently, that the process is fair and that the proposals are comparable. Some questions may need to be answered verbally during the property tour, but follow this up with a written summary of the questions asked and the responses given, particularly if there were bidding parties that were unable to attend.
- Publicize and stick to the deadline. Not only will this be fair to all parties, but a company that has missed the deadline has given a telling indication of its performance. If the deadline is extended to ensure good proposals, extend it to all parties with a formal, written announcement.

Reviewing the Proposals

Once the proposals are received, review them against the selection criteria. Some of the criteria will be somewhat subjective, and that's OK. Picking a good property management agent (like picking a good employee) will (and should) be a partially subjective process.

As discussed, many operational issues revolve around a property's revenues and expenses.

CASH FLOW STATEMENT FORMAT

Casg Flow Category	Per Unit Per Year	Per Unit Per Month
Gross Potential Income	$6,372	$531
Rent Loss	(566)	(47)
Other Income	237	20
Effective Gross Income	$6,043	$504
Marketing Expense	115	10
Payroll Expense	655	55
Management Fee	284	24
Other Administrative	140	12
Non-Housing Services	0	0
Utilities	430	36
Protection	10	1
Maintenance	548	46
Real Estate Taxes	560	47
Property Insurance	102	9
Capital Expenditures	391	33
Operating Expenses	$3,235	$270
Net Operating Income	$2,808	$234
Debt Service	2,340	195
Asset Management Costs	0	0
Cash Flow	$468	$39

Based on the 1994 National Apartment Association Income and Expense Survey, national average for individually metered market rate garden apartments. This example assumes a 1.20:1 debt service coverage ratio and makes no allowance for asset management costs.

Experienced owners and managers realize that each line item in the property's budget poses its own operational challenges. The following section reviews some of the more prominent revenue and expense issues within the major revenue and expense categories typically found in an apartment property's cash flow statement.

A Guided Tour of the Cash Flow Statement

First, it is important to underscore why apartment operators concentrate on the cash flow statement rather than on a traditional accounting income statement and balance sheet. The traditional accounting reports focus on *net income* and *net assets*. By contrast, apartment operators focus on *cash flow* and *market value*. Traditional accounting net income differs from cash flow in important ways, including:

- **Non-cash income** – Traditional accounting recognizes revenue when it is *earned*; a cash flow statement recognizes income when it is *collected*.
- **Non-cash expenses** – Traditional accounting includes non-cash expenses that recognize large initial expenditures (for example, for buildings and financing costs) bit by bit over a long period of time. These *depreciation* and *amortization* expenses are valid for accounting purposes but do not represent cash expenditures. Accordingly, they are of little or no interest to apartment operators.
- **Non-revenue cash inflows** – Apartment operators pay close attention to all cash that comes into the property, whether an accountant would call it "income" or not. Examples include withdrawals from the Reserve for Replacements account.
- **Non-expense cash outflows** – Two very large cash outlays that are important to apartment operators but are not classified as "expenses" by accountants are principal payments on the property's mortgage debt, and deposits to the Reserve for Replacement.

These are by no means all of the differences between cash flow and net income. As asset managers and property managers say, "I can't pay the bills with accounts receivable."

Similarly, accounting *net assets* (or retained earnings, fund balance, or net worth) is not particularly useful to asset managers and property managers because what they care about is a function of the property's market value. The amount a lender will lend has everything to do with the property's market value and almost nothing to do with the owner's net worth. As asset managers and property managers say, "I can't borrow the net worth."

The following discussion will highlight operational issues that arise in the major revenue and expense categories of the cash flow statement.

Gross Potential Income is the rental income the property would collect if all apartments were occupied at the full rent and all the rent were collected.

Gross Potential Income is the rental income the property would collect if all apartments were occupied at the full rent and all the rent were collected. For market-rate properties, the "full rent" is generally the maximum rent that the owner can sustain in the marketplace. By contrast, affordable properties typically operate within maximum rent limits—rents based on actual property needs, or both. Expert managers stress the importance of forecasting the property's financial needs accurately, so that rents can be set at a level that is consistent with the property's needs *and* the property's affordability mission. Failure to charge enough rent in the early years of an affordable property is a frequent cause of property failure in its later years.

Rent Loss occurs for three reasons:

- *Vacancy loss* from apartments that are not occupied;
- *Concession loss* from apartments rented for less than the full rent; and
- *Bad debt loss* from residents who did not pay the full rent.

Regarding *vacancy loss*, property managers typically work very hard to make vacant apartments rent-ready as quickly as possible in order to minimize vacancy loss between occupancies. Similarly, property managers work very hard on marketing to assure that the property experiences a sufficient volume of interested and qualified prospects again so that vacancy losses

are minimized. Vacancy loss is related directly to the relationship between the property's rents and market rents—if the property's rents are at market levels, the property will probably experience a market-average level of vacancy (typically six to ten percent). If the property's rents are materially below market, the property will probably experience a below-market-average level of vacancy (as low as two to three percent for a property with rents well under market). The lowest vacancy rates are experienced by properties with *deep subsidy* programs, such as Section 8, that keep residents' rents several hundred dollars below market. Deep subsidy properties sometimes achieve vacancy rates of one percent or slightly less.

Concessions are the most common way that managers of market-rate properties adjust rents in periods of temporary market weakness. Typical concessions include installation of a ceiling fan or microwave oven, a reduced security deposit, or a discount on the first month's rent. Experienced owners and managers know that an apartment that is occupied at a reduced rent is more productive than one that is vacant.

Bad debt losses are a function of how rigorous management's resident selection criteria are plus how persistent management is about collecting rents. Most expert managers believe that zero bad debt loss is a bad sign (the property is being too selective in its search for qualified tenants and is probably sustaining more vacancy losses than necessary). Conversely, bad debt losses above about one percent of gross potential rents usually signal that the property is not being selective enough or is not working hard enough on collections.

Other Income is income from sources other than the rents.

- *Financial other income* consists of interest earnings from the property's cash and investment accounts (such as Replacement Reserve funds being held for future capital expenditures). Some financial other income is available for property operations, and some is required to be held for other purposes (for example, some states require that interest on security deposit funds be returned to residents, and the interest on most Replacement Reserve funds is required to be added to the Reserve account).
- *Non-financial other income* includes items such as revenue from coin-operated laundry machines, revenue from vending machines, and revenue from service programs. Typically these amounts are quite small by comparison to rental income. However, many property management experts believe that in the future many market-rate properties will receive very significant income from non-housing services such as on-site computer and copy centers, on-site conference facilities, laundry valet services, transportation services, telecommunications services, cable services, and Internet services. Similarly, affordable properties may realize additional revenue by providing services needed by residents, and may use the revenue from these programs to offset their costs.

Marketing Expenses include advertising expense and the costs of preparing brochures and other marketing materials. Many managers include costs associated with leasing as well (commissions and referral fees to property staff or third parties and the cost of checking applicants' housing and credit histories); other managers classify these as administrative expenses. Even properties with below-market rents will require some marketing expenses, particularly at the time of initial lease-up and again during periods of local market weakness (when a previously below-market-rent property may find itself competing head to head with market-rate properties that have now reduced their rents).

Payroll Expenses include the wages for front line staff, the cost of their health and other benefits, and payroll taxes (employer portion). The *payroll loading factor* for benefits and payroll taxes will vary from a low of perhaps 15 percent for a property that provides no employment benefits to perhaps 25 to 35 percent for properties with significant employee benefit packages. Experienced owners and managers believe that significant benefit packages make economic sense because they encourage front line staff to approach property management as a career rather than just a job. Good benefit packages help attract and retain top quality front line staff—one of the three success factors of property management (see page 9).

The *Property Management Fee* is paid to the property management company for providing the services required under the property management agreement. The fee covers the property management company's operating costs (primarily payroll costs for non-front line staff, the management company's office and travel costs, and its accounting systems) plus its profit (see page 6).

Other Administrative Expenses include on-site office costs (telephone, computer costs, copying, printing, office supplies, postage), training for front line staff, the cost of preparing audited financial statements, and legal costs (typical legal costs are related to lease enforcement or disputes with contractors).

Utilities include those utility costs that are paid by the property, including utility costs for vacant units and *common areas* which include:

- the office;
- community room;
- laundry facility;
- maintenance shop;
- exterior lighting; and
- recreational facilities such as swimming pools.

All utility costs are a function of the utility rate and usage. Reductions in the total cost of utilities are realized by either reducing the rate or the usage, or optimally, both.

Since the 1970s, the great majority of properties have been designed with resident-paid electricity. Similarly, most newer properties using natural gas for heat use individual natural gas meters. Experience has shown that residents consume significantly less energy if they pay the utility bill themselves (utility companies typically estimate a 30 to 40 percent reduction in utility usage when properties convert from owner-paid to resident-paid utilities). Until recently, most properties paid for water and sewer charges, partly because local utility companies offered much lower rates to large users like apartment properties and partly because this approach saved the cost of installing individual meters. Today, many developers are including individual water meters in new developments in response to rising water and sewer charges as well as community concerns about water conservation.

Non-Housing Services are increasingly common in affordable rental housing. Low-cost service programs include:

- On-site recreational programs such as crafts classes offered by local community centers at little or no cost to the property;
- Group trips for which residents pay most or all of the cost; and
- On site health-related programs (such as a visiting nurse who does blood pressure checks or provides education on health-related topics or a podiatrist who has office hours at the property once a week).

Modest-cost service programs include:

- After-school activities for children (using some or all volunteer adult staff);
- Summer recreational programs for children (especially those partially or fully underwritten by local government or local charities);
- GED programs for adults (usually offered at little or no cost through the local public schools); and
- Job-readiness classes, job-skill development classes, and other support for adults who are making the transition from welfare to work (often these classes can be coordinated on-site at little or no cost to the property).

Higher-cost service programs include:

- Resident service coordinators provided at property expense (typically to bring additional no-cost and low-cost programs to the property);
- Caseworkers provided at property expense (to directly deliver supportive services to residents);
- Subsidized meals programs;
- Van and driver provided at low cost or no cost to residents; and
- Computer centers (used by children for educational purposes and by adults for welfare-to-work purposes).

Protection Costs sometimes are required in high-crime neighborhoods. As a general rule, the need for protection costs can be minimized through careful architectural design using "defensible space" approaches and by developing a spirit of community among residents, thereby making the property more inherently crime-resistant. Properties that are attractive, well-maintained, and free of graffiti and debris are much less likely to be frequented by drug dealers and other criminals than properties that transmit a message that owners and residents are apathetic. Other factors important in making the property crime-resistant include excellent exterior lighting, the degree to which access into the property can be controlled, and whether there are areas in which criminal activity can occur without being observed by residents and passers-by.

Normal Repairs expenses include:

- Grounds maintenance costs such as mowing, planting, leaf removal, snow removal, and mulching;
- Vacant unit make-ready (removing any debris left by the vacating resident, patching walls, repairing wear and tear, repainting, and cleaning);
- Routine minor maintenance such as regrouting tubs, repairing plumbing leaks, replacing furnace filters, and replacing window screens; and
- Responding to service requests from residents.

As the cost of repairs accelerate, items cross the line into *capital expenditures*. Different owners and managers define this dividing line differently; although everyone agrees that replacing fifty refrigerators is a capital expenditure, some would classify replacing a single refrigerator as a normal repair.

Real Estate Taxes are typically assessed by local government based on the value of each individual piece of real property. Typically, the local government will *re-assess* value every several years. Because this value must be estimated and because expert opinions of value will vary, expert owners and managers carefully scrutinize local government's estimate of value, often with the help of real estate tax professionals. Frequently, owners and managers challenge the *assessed value*. Many affordable rental properties have partial or full *real estate tax abatements* under which the property pays only a fraction of normal real estate taxes. Other affordable properties have a *payment in lieu of taxes* agreement (PILOT) under which the property pays a formula amount instead of a normal real estate tax based on the property's value. PILOT formulas vary by taxing jurisdiction but often are based on the property's rental revenues, thereby protecting the property against the risk that real estate tax expense will increase faster than the rents—an important protection, because many affordable properties have experienced financial crises as a result of rapid real estate tax increases.

Property Insurance has two main components:

- *Casualty insurance* protects the property against financial loss due to fires, windstorms, and other hazards.
- *Liability insurance* protects the property against financial loss because the property is determined to be liable for injury or damages sustained by residents or others. Perhaps the most common type of liability claim is a slip-and-fall injury.

Insurance costs are determined primarily by the insurance company's estimate of the likelihood of claims, the amount of coverage requested by the owner, and the size of the deductibles. Experienced owners typically find that *risk management* efforts to improve safety and reduce risk of fires and injuries are well worth their cost, because they result in lower insurance premiums. Although insurance companies consider industry statistics in determining the likelihood of claims, experienced owners also typically find that the actual *loss history* in their portfolio has a direct impact on their insurance premiums. Insurance premiums typically fluctuate due to changing financial conditions in the overall insurance industry; for example, after a year of abnormally bad storms, insurance premiums for all properties are likely to rise.

If a participating jurisdiction has a soft second or third mortgage on the property, it will often request to be listed on the owner's insurance policy as an interested party. This action will allow the participating jurisdiction to automatically receive a copy of the policy when it is renewed and to be alerted if it is cancelled or if damage has occurred to the property. Receiving these documents will assist participating jurisdictions in monitoring the property during the period of affordability.

Capital Expenditures are costs incurred for replacement or major repair of major building systems such as roofs, appliances, floor coverings, and heating systems. Most apartment properties make monthly deposits into a *Reserve for Replacements* to build up funds for future capital expenditures. If the Reserve deposits are sized properly, the Reserve fund will be sufficient to pay for needed capital expenditures as the various major building systems wear out; if not, the property will face periodic financial crises.

Net Operating Income (NOI) is the real estate industry term for the cash flow generated by the property before mortgage payments and before paying any return to the property's equity providers. The amount of NOI (taking into account its likely future stability, growth, or erosion) is the

most important factor in determining the market value of income-producing real estate.

Debt Service includes *principal*, *interest*, and *credit enhancement* costs for the property's mortgage financing.

- Traditional mortgage loans require equal monthly payments for principal and interest; normally, an affordable property's first mortgage loan will follow this pattern. These loans are sometimes called *level annuity monthly payment (LAMP)* loans.
- Affordable properties often have subordinate financing with principal and interest payments that either are deferred for some period of time, payable only to the extent of a percentage of cash flow, or perhaps have lower payments in early years and higher payments in later years. These loans are sometimes called *soft loans* or *contingent loans*.
- Credit enhancement costs are paid to obtain lower mortgage interest rates by inducing a highly creditworthy entity (such as a government agency or a large bank) to guarantee or insure the property's mortgage loan. Credit enhancement costs include *mortgage insurance premiums* (such as the premiums for FHA mortgage insurance) and *guarantee fees* (such as the guarantee fees paid to large banks in credit-enhanced housing bond issues).

Asset Management Costs represent the owner's cost to provide oversight of the property management agent, and to carry out the operational functions of the owner (budget approval, major capital expenditure approval, interaction with regulatory agencies, negotiating renewal or replacement of the property management agent). For-profit ownership entities typically provide for an asset management or partnership management fee to cover these costs, typically paid from property cash flow. Asset management costs often become an issue in affordable housing properties, at least in the following situations:

- When regulatory structures prohibit cash flow distributions to the owner (thereby giving the owner no source of funds for covering asset management costs).
- When property regulatory structures prohibit payment for asset management costs (on the regulatory theory that asset management costs should be supported from non-property funds).
- When properties' cash flow is fully pledged to the providers of equity (without allowing for asset management costs).

Clearly, if a not-for-profit sponsor must dip into its own pocket to cover its asset management costs, there is a risk that the property may not receive sufficient attention from the sponsor. When reviewing financing proposals for rental housing developments, participating jurisdictions should satisfy themselves that there will be sufficient asset management attention to the property (see also page 54).

Apartment Cash Flow is Highly Sensitive					
Cash Flow Category ($000 omitted)	Base Case	——Scenario——			
		A	B	C	D
Gross Potential Income	$396	$405	$396	$396	$387
Rent Loss	(20)	(12)	(28)	(28)	(27)
Other Income	7	7	7	7	7
Effective Gross Income	$383	$400	$375	$375	$367
Operating Expenses	165	150	165	180	180
Net Operating Income	$218	$250	$210	$195	$187
Debt Service	200	200	200	200	200
Asset Management	10	10	10	10	10
Cash Flow	$8	$40	$0	($15)	($23)
Assumptions:					
Gross Potential Rents (/unit/mo)	$660	$675	$660	$660	$645
Rent Loss	5%	3%	7%	7%	7%
Expenses (/unit/yr)	$3,300	$3,000	$3,300	$3,600	$3,600

Net Cash Flow (or "free cash flow") is the property's cash flow remaining after payment of debt service and asset management costs. Net Cash Flow is highly vulnerable to shifts in gross potential rents, rent loss, and operating expenses. The four scenarios (A, B, C and D) illustrate the dramatic effect that small changes in income and expenses can have on cash flow.

Chapter 2

Sensible Financing

Affordable housing properties generally have less ability to recover from financial surprises than market-rate properties. Accordingly, experienced developers and financiers advise sponsors of affordable rental housing to be especially careful in estimating a proposed property's revenues and expenses, to include adequate Replacement Reserves, and to limit the property's debt service to an amount that the property can reliably carry, especially as the property ages.

Affordable Rental Housing Requires Special Financing Approaches

Important financial differences between market-rate and affordable rental housing include:

- **Affordable rents = below market rents** – Affordable properties, in general, have rents that are less than those of market-rate properties because they are designed to be affordable to lower-income households. However, operating expenses typically are as high as, or higher than, those of comparable market-rate properties. This combination produces lower net operating income and, therefore, less ability to support debt and equity and, as a result, the need for gap funding such as loans or grants under the HOME Program.
- **Below market rents = high expense ratios** – For the same reasons, affordable properties have higher *operating expense ratios* (the relationship between operating expenses and property revenue). Affordable properties are therefore more vulnerable to unanticipated increases in operating costs and, thus, involve increased financial risk.
- **Below market rent = less risk** – Some affordable properties have below-market rents thereby making the property less financially risky (because, if necessary to solve a financial problem, rents can be increased subject to compliance with the HOME Program regulations).
- **Rent caps reduce financial flexibility** – Many affordable properties have *rent caps* that prohibit rents from increasing above a formula level. This reduces the property's ability to solve financial problems by increasing rents, thereby making the property more financially risky. Also, depending on the rent cap formula, there is the risk that the rent cap may grow more slowly than the property's operating costs, which could create a financial crisis several years down the road. Under the HOME Program, rent caps are called Low and High HOME Rents. See Chapter 3 for additional information.
- **Rent increases are not necessarily a good thing** – Many sponsors of affordable properties deliberately intend for rents to increase more slowly than market rents, thereby increasing the property's affordability over time. Similarly, government programs typically impose restrictions on rent increases (such as the HOME Program's requirement that increases in the maximum rents are tied to increases in area median incomes / Fair Market Rents). By contrast, operators of market-rate apartment properties typically will increase rents whenever it is possible.
- **Fewer ways to finance capital expenditures** – As is discussed in more depth in the next section, market-rate properties can pay for future capital expenditures from several sources. Affordable properties typically must finance capital expenditures solely from the Replacement Reserve and the normal repairs budget. As a result, affordable properties will most often require larger Replacement Reserve deposits.
- **Limited cash flow = limited equity** – Many affordable properties have regulatory structures that limit the amount of cash flow that can be generated by the property. These types of restrictions limit the amount of equity capital that the property can attract.
- **Unusual operating expenses** – Many affordable housing properties include non-housing service costs and/or resident empow-

erment costs, thereby increasing operating expenses beyond levels that would be typical for otherwise comparable market-rate properties.

As a result of these significant differences, experienced real estate professionals approach the financing of affordable rental housing with a willingness to look past traditional rules of thumb for market-rate apartments.

Sensible financing must be based on sensible estimates of the property's net operating income. The following sections discuss issues that must be considered when *underwriting* (estimating for financing purposes) each aspect of the property's Net Operating Income.

Sensible Rent and Rent Loss Estimates

Many affordable properties were developed based on estimated rents that were not attainable, even though they appeared to be "affordable." These properties typically required debt restructuring or other types of workouts soon after construction completion—combining financial losses with acute embarrassment.

Sometimes, developers assumed that their property could charge the maximum rents allowable under their affordability program, when a careful analysis of the local market would have suggested otherwise. For example, the maximum HOME rents (High HOME Rents) are always "affordable," but may be well above market in some neighborhoods and well below market in other neighborhoods. Sponsors are advised to commission a professional *market study* to determine the rents that the market will allow. Owners should be aware that High and Low HOME Rents are the maximum rents that eligible tenants pay. Rents do not have to be set at those limits. If the market demands a lower rent, there are no restrictions on charging less than the published High and Low HOME Rents.

Sometimes, developers overestimated rents by underestimating the adverse marketing impact of the property's affordability programs. For example, if residents have to certify (and annually recertify) their incomes at an affordable property but not at the market-rate property next door, it stands to reason that residents will not choose the affordable property unless its rents are lower.

Sometimes, developers underestimated the effect of the affordable property's *resident income limit* that restricts the property's target market to households below a given income level. Experienced developers and managers draw two lessons from their experience with resident income limits:

- **Broad band of eligible households** – The property's rents must be affordable to many households within the eligible income range, not just to those at the very top of the range. Otherwise, the property will have too few target households who can both meet the income limit and afford the rent.
- **Excluding higher-income households has a cost** – If the income limit excludes any significant number of households who might otherwise wish to live at the property, the property's rents must be at least ten percent below the rents that an otherwise comparable market-rate property (without the income limit) could command.

In still other instances, developers were simply too optimistic, a problem that occurs with equal or greater frequency in market-rate apartments. However, this error can be more critical in an affordable property because, typically, affordable properties have less ability to accommodate financial surprises than market-rate properties.

If an affordable property's rents truly are below market, the developer is justified in projecting a below-market-average level of rent loss. However, if the developer has made one of the rent-estimation mistakes discussed in the previous section and the property's rents are at market (or close to it), the property is likely to experience higher than projected levels of rent loss as well.

Another common rent-loss underwriting error is to assume that because the market vacancy level is low today, it will remain low in the future. Real estate markets fluctuate, and typical vacancy rates vary from six percent or less to ten percent or more over a typical market cycle. Prudent developers and lenders estimate rent loss using *market cycle average* vacancy rates.

Sensible Operating Expense Estimates

When considering the development of an affordable rental housing property, sponsors should obtain actual operating expense data for several comparable properties—of similar size, similar design, and serving a similar resident profile. Starting with this comparable operating expense data, sponsors should then work with asset

management and property management experts to identify adjustments to arrive at sensible operating expense estimates for the property the sponsor wants to develop.

By contrast, sponsors who rely on rules of thumb (such as "apartments cost $X per unit per month to operate" or "operating expenses are Y percent of rental income") are taking large risks when reality is different from the rule of thumb.

In estimating operating expenses, sponsors should consider the likelihood that actual results will differ from even the best projections such as in these circumstances:

- The wage rates necessary to attract top quality front line staff may be higher or lower than estimated;
- Resident turnover rates may vary from projections;
- The local government may have to increase real estate taxes dramatically—for example, to pay for new roads or schools;
- The local water district may have to increase water rates significantly to pay for a new sewer plant or improved pollution control; or
- The property may prove more or less challenging to market than expected.

Sponsors who rely on rules of thumb are taking large risks when reality is different from the rule of thumb.

Accordingly, experienced sponsors project operating expenses that represent a reasonable balance between the low expenses that will occur if all factors are favorable and the higher expenses that will occur if all factors are unfavorable.

Two additional operating expense considerations are specific to affordable rental housing:

- **Non-housing services** – The sponsor's intended package of non-housing services will impact the operating expenses even if a low-cost package is selected. Property staff will still have to coordinate and manage the services, and the property will still have to bear some cost for utilities, supplies, cleaning, and copying.
- **Resident empowerment** – Experienced resident organizers advise that helping residents form a community and develop a resident organization requires large amounts of time, much of it outside normal working hours. They also advise that although the organizer's role will change over time, a successful resident organization will require significant support from an organizer on an ongoing basis. Sponsors who intend to achieve significant resident participation in property governance should include appropriate support costs in the property's budget.

Sensible Debt Service Coverage: A Margin of Safety

Debt service coverage is a real estate financial term that expresses the relationship between net operating income and the property's required debt service. For example, a 1.20 *debt service coverage ratio* means that each dollar of debt service is supported by $1.20 of estimated net operating income, a twenty percent safety margin. Typical debt service coverage ratios for market rate apartments are in the 1.20 to 1.60 range.

When affordable housing properties are conservatively structured with rents at least ten percent below true market levels, adequate operating expenses, and adequate Replacement Reserves, lenders usually regard these properties as less risky than typical market rate properties and will allow debt service coverage ratios as low as 1.05 to 1.10.

Conversely, affordable housing properties that involve rents at or close to market levels, aggressive operating expense estimates, and minimal Replacement Reserves—even without adding special affordability features like resident income limits or restrictions on rent increases, adverse market features such as location in a troubled neighborhood, or a difficult-to-serve target clientele such as a transitional homeless population—are significantly more risky than market-rate properties. These higher risk levels will result in some lenders being unwilling to lend at all, and the remaining lenders will demand correspondingly higher debt service coverage ratios.

Sponsors should perform their own analysis of the relative risk level of their properties and of

their own tolerance for risk and should insist on a margin of safety that reflects the inherent riskiness of their property and the sponsor's level of comfort with that risk.

Sensible Strategies for Financing Capital Needs

Especially as a property ages, property managers and asset managers spend considerable time planning the financing for major repairs and replacements. The three major strategies are:

- **Past cash flow** – using the property's past cash flow in the form of accumulated cash such as the Replacement Reserve account;
- **Future cash flow** – using the property's future cash flow by borrowing money now to be repaid from future cash flow; and
- **Miracles** – trusting that the skies will open and free money will rain down ("free" in the sense that it does not have to be repaid from the property's cash flow).

Unfortunately, in affordable rental housing the third strategy has played a major role due to wishful thinking by policy makers and sponsors alike. Sometimes, no one worried about long-term capital needs because twenty years is a long time, and it would be someone else's problem. When policy makers and sponsors did think about long term capital needs, they assumed that the necessary funds would come from government:

Until the Tax Reform Act of 1986, policy makers and sponsors could rely on tax shelter resyndication. Under pre-1986 tax law, it was reasonable (although by no means certain) to assume that a purchaser could receive enough income tax benefits to afford to pay enough to compensate the seller *and* to fund the property's capital needs.

Since 1986, a limited amount of "free money" has been available through the Low Income Housing Tax Credit. However, the credits are limited by law and are highly competitive.

Since 1990, some participating jurisdictions have made investments under the HOME Program to meet the accumulated capital needs of affordable rental housing properties. Like the Low Income Housing Tax Credit (LIHTC), however, HOME Program funds are limited by law, and participating jurisdictions typically have many competing uses for their limited HOME funds.

In summary, since 1986 prudent policy makers and sponsors have been unable to count on "free money" to meet the capital needs of affordable rental housing. This shift in the financial reality of affordable rental housing has profound implications for operations and, as we will see, for initial financing as well.

Sensible Tactics for Financing Capital Needs

When an apartment property needs $100,000 to replace the roofs, the asset manager and property manager must find $100,000 from either the property's past cash flow, its future cash flow, or a combination. What are the various funding sources that might be available?

- **Replacement Reserve** – The simplest source, but one that requires setting Reserve deposits at the correct level many years before the roof wears out.
- **Normal Repairs Budget** – Many properties include amounts in the Normal Repairs budget to cover some capital expenditures.
- **Current Cash Flow** – If the property has a significant cash flow, at least some capital expenditures can be funded from current earnings.
- **Rent Increases** – If the property's current rents are below market (or if the capital expenditures will increase the market value of the property), at least some of the capital expenditures can be funded from increased rents, subject to HOME rent increase regulations (see 24CFR §92.252(f)(3)). Any increase for HOME-assisted units is subject to the provisions of outstanding leases, and in any event, the owner must provide tenants of those units not less than 30 days prior written notice before implementing any increase in rents.
- **Expense Savings** – If the capital expenditures reduce the property's operating expenses (for example, new windows may reduce the property's utility costs to some extent), the savings can help pay for the capital expenditures.
- **Refinancing** – If the property has significant cash flow, has an above-market mortgage interest rate, or is near the end of its mortgage term, the owner may be able to refinance the property with a new, larger mortgage loan

using some of the new loan to pay for capital expenditures. The owner should keep in mind that if the participating jurisdiction has a soft second or third mortgage on the property, the first lender may require the participating jurisdiction to subordinate (or lower) its lien position through a written subordination agreement. The subordination agreement must be executed before or at the loan closing. Subordination policies vary among participating jurisdictions. Some have strict and lengthy review processes, while others will sign an agreement with a limited review. The owner should contact the participating jurisdiction before refinancing to avoid any delays at the closing table.

- **New Equity** – If the property has significant cash flow, the owner may be willing to invest additional equity capital to cover the cost of capital expenditures.

For affordable properties, however, most of these potential sources will not be available. Affordable properties, almost by definition, do not have significant cash flow, do not want to increase rents, and often cannot refinance or bring in new equity because of their financing and affordability structures.

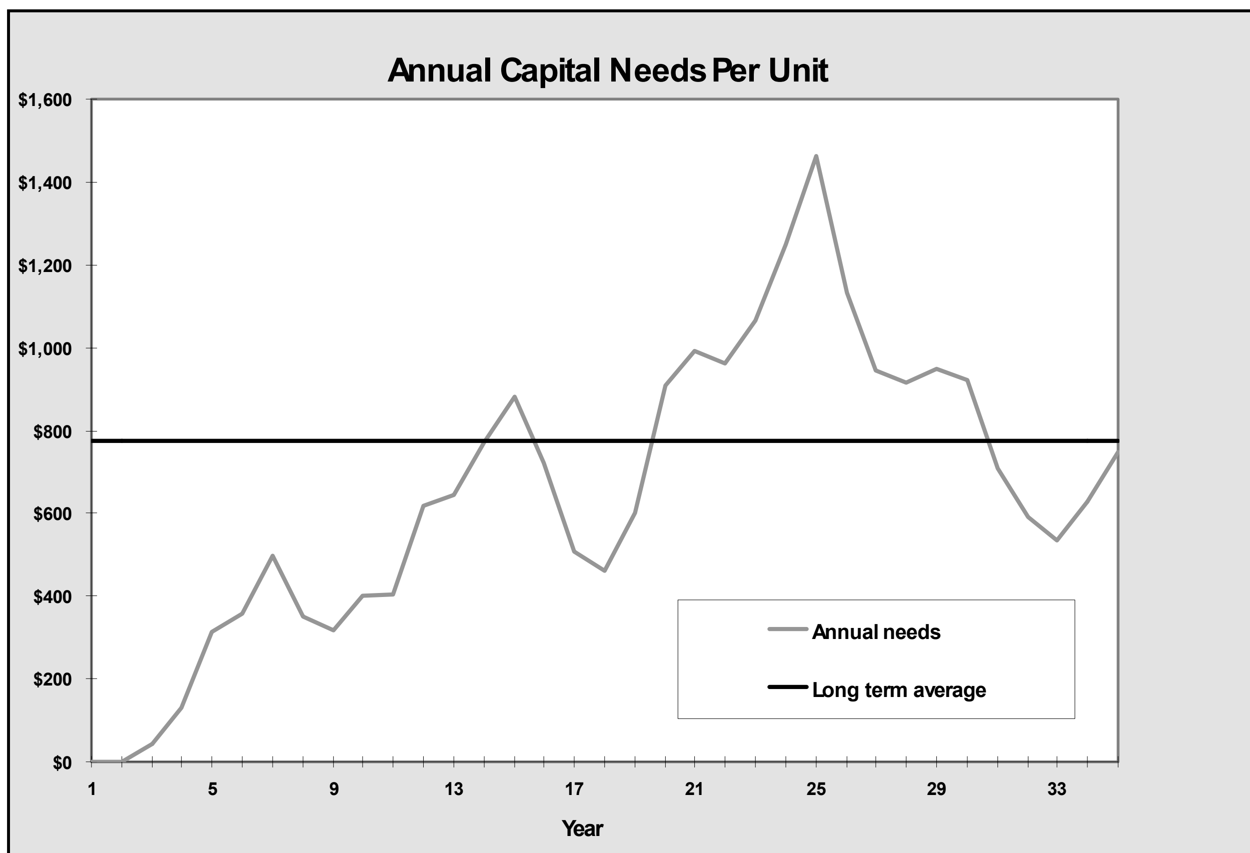
Eventually, everything wears out.

Accordingly, sensible capital needs financing for most affordable rental housing means including an appropriately sized (i.e., large) Replacement Reserve deposit in the property's initial financial structure. If the property did not have an adequate Reserve deposit in its initial structure, typically the asset manager and property manager have to make some very painful choices as the property ages.

Sensible Capital Needs Planning

Eventually, everything wears out. This simple truth leads to some profound financial consequences for affordable rental housing. In the early years of a property, everything is new, nothing requires replacement, and life is easy. As the property ages, more of the original building systems wear out and require replacement. In a typical property's 20- to 30-year life between development and major rehabilitation, annual *capital needs* will increase dramatically.

The graph below illustrates the capital needs that a newly constructed garden



apartment property might experience, in dollars per unit per year (and ignoring inflation).

One lesson from this graph is that the long-term average needs (approaching $800 per unit per year) are somewhat higher than most market-rate apartment properties' Replacement Reserve deposits. This is because market-rate properties typically fund only a portion of capital needs from the Reserve, with the balance being funded from cash flow and/or periodic refinancing. As discussed in the previous section, affordable properties typically must fund capital needs entirely from the Reserve. Accordingly, affordable properties often need a much higher Reserve deposit than is typical for market-rate properties. For the property illustrated in the chart, an adequate Reserve deposit will be equal to or close to the long-term average needs (in this case, approaching $800 per unit per year).

Another lesson is that the annual capital needs fluctuate dramatically from year to year. Therefore, in addition to an adequate Reserve deposit, asset managers and property managers need a Reserve balance that is sufficient to accommodate years when the property's capital needs are larger than the Reserve deposit. For the property illustrated in the chart, the largest annual capital needs are roughly twice the annual average needs. In addition, the property undergoes extended periods in which the annual capital needs exceed the average needs. Therefore, a prudent minimum Reserve balance would be at least two year's Reserve deposits and could well be higher. For example, if the property is facing several years in a row with capital expenditures in excess of the Reserve deposit, an especially large initial Reserve balance will be required.

Although the annual capital needs fluctuate fairly widely, they do follow a pattern. Annual needs are very low in the first few years and then escalate rapidly. Annual needs reach a peak between years 20 and 30, when some very expensive systems begin their first cycle of replacement (kitchen cabinet replacement, parking lot resurfacing, siding replacement, window replacement). After year 30, capital needs fluctuate but remain at a high level.

A final lesson is not shown in the graph: each property's capital needs will follow a property-specific pattern, influenced by the materials specified by the architect and installed by the contractor, the resident profile, the climate, and other relevant factors. Prudent sponsors size the initial Replacement Reserve deposit based on a property-specific *capital needs assessment* based on the expected useful lives and expected replacement costs of the property's major building systems.

Furthermore, prudent asset managers and property managers commission updated capital needs assessments every five to ten years to reflect how the property's major building systems are actually aging and updated replacement costs. Based on the updated capital needs assessment, the property's Replacement Reserve deposit strategy can be fine-tuned. If systems are wearing out faster than expected (or cost more to replace than expected), Reserve deposits must be increased. Conversely, if the property's actual experience is favorable, deposits can be decreased and/or Reserve funds can be released for other uses.

Sensible Loan Features

For this discussion, it will be helpful to look at an example using loan terms that sponsors may encounter in financing affordable rental housing:

- $1,000,000 loan amount;
- 7.5 percent interest rate;
- 30-year *amortization* (i.e., the loan payments are sized so that 30 years of payments will amortize, or pay off, the loan);
- Monthly payments are roughly $7,000;
- In the first month, roughly $750 of the monthly payment will be applied to *principal* (i.e., to reduce the outstanding loan balance) and the remainder will be applied to interest; and
- In each succeeding month, an increasing amount of the payment will be applied to principal and a decreasing amount will be applied to interest.

In general, the lower the interest rate, the lower the monthly payments. Similarly, a longer amortization period also translates into lower monthly payments—and a correspondingly slower payoff of the loan.

Rate of Amortization

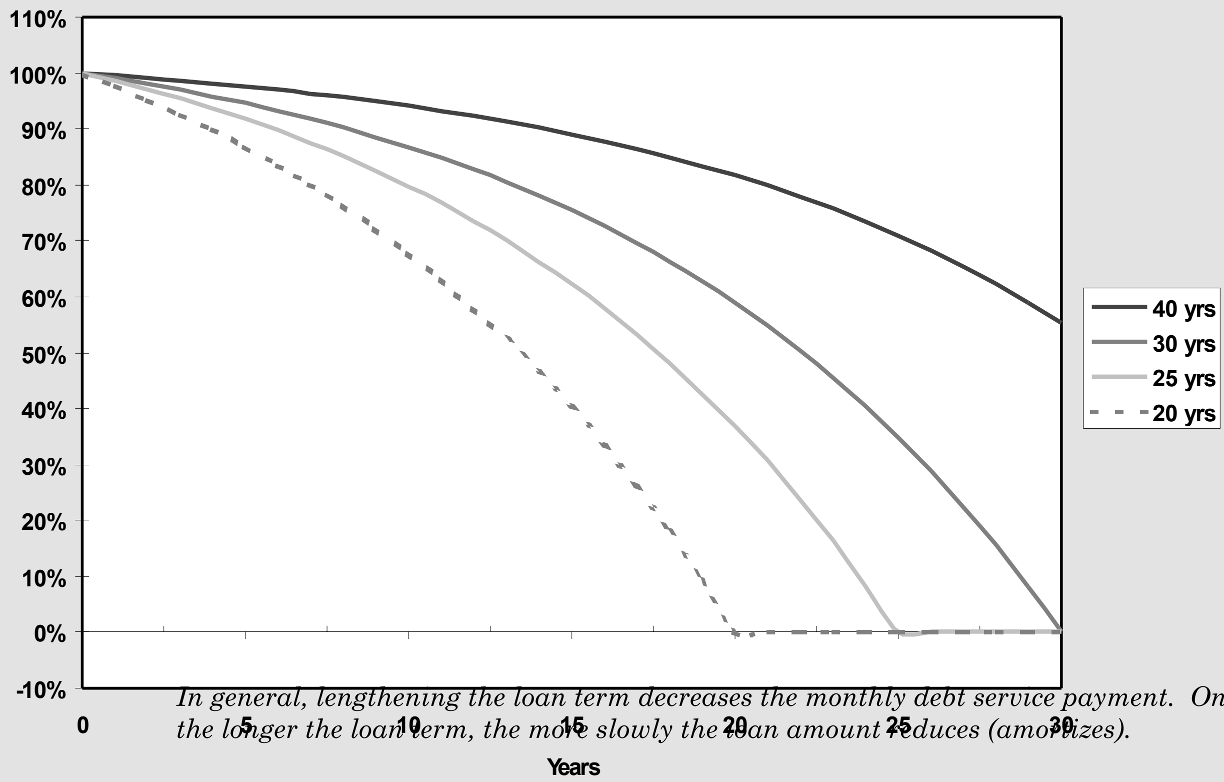
A *self-amortizing loan* is a loan that is fully repaid at the end of the *loan term*. The traditional mortgage loan is an example: when the 15- to 30-year loan term is over, the loan balance will be zero. If the loan is self-amortizing, its loan

term will be equal to its amortization period (in this example, 30 years), and the sponsor will not be required to refinance in the future. Conversely, the loan may have a shorter loan term requiring the sponsor to refinance the loan when it still has a significant balance remaining.

Some multifamily mortgage loans are self-amortizing; the Federal Housing Administration's (FHA's) multifamily mortgage loans are the leading examples. Today's typical multifamily loan, however, will be due at a time when a significant balance remains. Most multifamily loans use a 30-year or 25-year amortization period but are due in 5, 7, or 10 years. The reason for the shorter loan term is that many more multifamily lenders will lend for five- to ten-year terms than are willing to lend for longer terms. Accordingly, loans with five to ten year terms have significantly lower interest rates under typical financial market conditions. That's the good news.

The bad news is that the sponsor incurs a *financing risk*: five to ten years later when the loan must be paid off, will interest rates be dramatically higher than they are today? If so, the sponsor may have difficulty borrowing enough money to pay off the loan. Of course, interest rates could be lower at that time, which would make it easier to pay off the loan.

The point of this discussion is not to recommend one form of financing over another, but to point out that sensible financing strategies will vary depending on the form of mortgage financing selected by the sponsors. If the sponsors decide to take a financing risk in the future (in order to achieve a lower interest rate now), prudence dictates a larger built-in cash flow, so that the property can afford higher mortgage payments in the future, if necessary. Conversely, if the sponsors use a self-amortizing mortgage loan, they can afford to build in a smaller margin of safety in the property's cash flow.



In general, lengthening the loan term decreases the monthly debt service payment. On the other hand, the longer the loan term, the more slowly the loan amount reduces (amortizes).

Loan Term

In general, lengthening the loan term decreases the monthly debt service payment. On the other hand, the longer the loan term, the more slowly the loan amount reduces or amortizes. The chart on the previous page illustrates the rate of amortization for loan terms of 20 to 40 years.

Suppose that you expected to need to borrow money after 15 years in order to finance capital expenditures. You would prefer to have a 25-year loan term; after 15 years, you would owe 60 percent of the original loan amount. By contrast, if you had a 40-year loan term, you would owe almost 90 percent of the original loan amount after 15 years.

The chart is based on an interest rate of 7.5 percent. In general, loans with low interest rates amortize more quickly than loans with higher interest rates. Accordingly, the shape of the amortization curves will be different for different interest rates. Of course, no matter what the interest rate, the shorter term loans will always amortize faster than the longer term loans.

Following are some general principles that are useful in deciding how to structure the mortgage financing for affordable rental housing properties:

- Use self-amortizing financing whenever possible. This avoids the risk that interest rates will rise dramatically at the time the property must be refinanced.
- Properties with healthy Reserve deposits and conservative projections of NOI can use longer amortization periods. These properties can afford the slower payoff pattern, because they are relatively unlikely to have to borrow additional funds to finance capital expenditures.
- Conversely, properties with aggressively projected NOI and thin cash-flow margins should use shorter amortization periods. These properties are very likely to need to borrow additional funds after 10 to 15 years to finance the capital expenditures that the operating budget cannot support. Therefore, these properties need a relatively fast loan payoff pattern to create room for future borrowing.

Chapter 3

Introduction to HOME Program Compliance

The HOME Program compliance requirements are published in the Code of Federal Regulations at 24 CFR Part 92. See the HOME Final Rule publication for the full text of the regulations. The following discussion is only a summary of certain HOME Program requirements.

The High and Low HOME Rent Requirement – 24 CFR §92.252(a) and (b)

At initial occupancy, rents for HOME-assisted units must not exceed HUD-prescribed maximum rents. With the exception of one- to four-unit rental projects, every rental project has two HOME rent levels: "High HOME Rents," and "Low HOME Rents." These are published annually by HUD for each locality. New rents are effective upon receipt of the new HUD published figures. However, tenants' rents should not be adjusted until their leases are renewed.

Both the High and Low HOME Rents represent the maximum that tenants can pay for rent and utilities combined. These rents are also the maximum amount *from all sources* that the owner may receive for HOME-assisted units, including *both* tenant contributions and Section 8 or HOME-funded rental assistance. If the project receives project-based rental assistance for tenants with incomes at or below 50 percent of area median income, the rent limits from the project-based rental assistance program can be used.

High HOME Rents – These are the lesser of:

- The HUD Section 8 Fair Market Rents (or area-wide exception rents) for existing housing in the local market area adjusted for unit size; or
- 30 percent of 65 percent of *median income* (as published by HUD), including adjustments for the number of bedrooms.

The Fair Market Rents (FMR) are statistically determined for each Metropolitan Statistical Area and each non-metropolitan county. The FMRs represent market rents for modest-quality market-rate rental housing.

The High HOME Rent calculation takes resident-paid utilities into account. If a HOME-assisted property requires residents to pay certain utilities, the estimated cost of those utilities (or *utility allowance*) is subtracted from the High HOME Rent limit.

Residents of High HOME Rent units must meet income eligibility requirements, discussed later in this chapter.

Sample Calculation for High and Low HOME Rents for Two-Bedroom Units						
Sample, USA	Efficiency	1 Bedroom	2 Bedroom	3 Bedroom	4 Bedroom	5 Bedroom
High HOME Rent	$331	$396	$466	$634	$710	$764
Low HOME Rent	$331	$381	$457	$529	$690	$751
For Information Only						
Fair Market Rent (FMR)	$331	$396	$466	$634	$750	$862
50% Rent Limit	$356	$381	$457	$529	$690	$751
65% Rent Limit	$442	$475	$573	$653	$710	$764

The current HOME rents are available at: http://www.hud.gov/cpd/home/limits/rent/rentlimt.html for all jurisdictions. See the instructions for calculating High and Low HOME Rents on the next page.

Low HOME Rents – These are calculated as 30 percent of 50 percent of the median income, adjusted for household size.

For properties with five or more HOME-assisted units, at least 20 percent of HOME-assisted units must have rents that are no greater than one of the following:

- The Low HOME rent; or
- Thirty percent of the tenant's monthly adjusted household income; or
- If a project has Federal or state project-based rental subsidy and the tenant pays no more than 30 percent of his or her adjusted income toward rent, the maximum rent may be the rent allowable under the project-based rental subsidy program. See Rent Setting, below.

In properties of five or more HOME-assisted rental units, at least 20 percent of the HOME-assisted units must meet one of these two tests:

- Low Rent Test: the rent is 30 percent of 50 percent of median income (adjusted for household size);
- Low Rent Burden Test: the rent does not exceed 30 percent of the household's adjusted income.

NOTE: The Low HOME Rent can never be higher than the High HOME Rent.

The sponsor may choose which method to follow. The first is simpler to administer and allows for more accurate projections of revenue. The second may provide greater affordability to the resident but will make it harder for the property to project cash flow.

Sample Calculation of High and Low HOME Rents for Two-Bedroom Units
First, obtain the raw data from HUD's Web site at: www.hud.gov/cpd/home/limits/rent/rentlimit.html The data will appear in the format of the chart on the previous page for each local area. To calculate the High HOME Rent, follow these steps:
1. On the sample rent chart (previous page), find the row labeled "Fair Market Rent" and follow this row over to the appropriate number of bedrooms for the unit.
2. On the rent chart, find the row labeled "65% Rent Limit" and follow it over to the column for the number of bedrooms in the unit.
3. Determine which of the two rents (the FMR or the 65% Rent Limit) is lower. This is the High HOME rent.
4. Subtract any tenant-paid utilities from the High HOME Rent established in Step 3. This is the maximum actual rent that can be charged to the tenant.
Using the sample chart, for a two-bedroom apartment the High HOME rent limit is the lesser of the FMR ($466) or the 65% Rent Limit ($573), or $466. Then subtract any utility allowance to arrive at the maximum amount that High HOME Rent-unit residents will pay.

Sample Calculation of Low HOME Rents for Two-Bedroom Units
Follow the steps outlined in the High HOME Rent sample calculation at left, EXCEPT that the 50% Rent Limit figures must be used instead of the 65% Rent Limit figures.
1. If a project receives Federal or state project-based subsidies and the tenant pays no more than 30 percent of his or her adjusted income for rent, the maximum rent may be the rent allowable under the project-based subsidy program.
2. If the Low HOME Rent as calculated above is higher than the High HOME Rent, then the High HOME Rent must be used. This can occur when the High HOME Rent is equal to the FMR and the FMR is lower than the Low HOME Rent.
3. Subtract any tenant-paid utilities from the Low HOME Rent established in Step 2. This is the maximum actual rent that can be charged to the tenant.
Using the sample chart for a two-bedroom apartment, the Low HOME Rent limit is the 50% Rent Limit ($457). Subtract any utility allowance to arrive at the maximum amount that Low HOME Rent-unit residents will pay.

Residents of Low HOME Rent units must meet income eligibility requirements discussed later in this chapter.

The Low HOME Rent calculation takes resident-paid utilities into account. If a HOME-assisted property requires residents to pay certain utilities, the estimated cost of those utilities (*utility allowance*) is subtracted from the Low HOME rent limit.

The Utility Analysis

The participating jurisdiction must approve the resident-paid utility amount that is subtracted from the High and Low HOME Rent Limits. Utility allowance amounts may be determined in any of the following ways:

- Determination by the local public housing authority;
- Determination by the participating jurisdiction; or
- Proposed by the property owner, with documentation and approved by the participating jurisdiction.

Sample Utility Adjustment			
High HOME Rent	$466	Low HOME Rent	$457
Utility Allowance	($50)	Utility Allowance	($50)
Maximum HOME rent for 80 percent of units	$416	Maximum HOME rent for 20 percent of units	$407

The utility allowance should be updated annually. The best time to do this is when rents change.

Rent Setting

Sponsors may always charge rents that are below the HOME limits. Expert managers recommend basing rent-setting decisions on a comprehensive, multi-year strategic plan for the property so that the rents will be set at a level that is consistent with the property's long-term viability.

There is also one situation in which sponsors may exceed the HOME rent limits. If the property has HUD Section 8 subsidies or similar state subsidies that are tied directly to the development (for example, project-based Section 8 certificates), the sponsor receives rental payments from both the resident and the subsidy program. The total of the two payments is allowed to exceed the HOME rent limits in this situation. In addition, the household's annual income must be equal to or less than 50 percent of median, and the household must not pay more than 30 percent of income (meeting the requirements of a Low HOME Rent household).

Section 8 Adjustments

Adjusted income is derived by subtracting any of the following deductions (also called allowances) that apply to the household from a household's annual (gross) income:

- $480 for each dependent (includes any of the following family members who are not the head of the household or spouse: persons under 18, handicapped/disabled family members, and full-time students);
- Reasonable child care expenses (for children 13 and under)—during the period for which annual income is computed—that enable a family member to work or to go to school, if no adult is available in the household to provide child care;
- For elderly households only, medical expenses, including medical insurance premiums, in excess of three percent of annual income that are anticipated during the period for which annual income is computed and that are not covered by insurance;
- Reasonable expenses in excess of three percent of annual income for the apparatus and care of a handicapped or disabled family member —anticipated during the period for which annual income is computed—that enable that person or another person to work;
- $400 for any elderly family (where the head of household or spouse is 62 or older or handicapped or disabled).

For a detailed discussion of calculating annual and adjusted income for the HOME Program, see the HOME model *Technical Guide for Determining Income and Allowances for the HOME Program.* For up-to-date rules and requirements, consult the regulations at 24 CFR, Part 5 (subpart F).

If, however, the property receives portable tenant-based assistance (under the Section 8 Program or any similar program), the HOME rent limits apply. Portable assistance means that the assistance stays with the resident if the resident relocates.

Participating jurisdictions are able to request a *HOME Rent Exception*: HUD's permission to exceed the HOME rent limits for specific properties in financial distress. In general, HUD will grant HOME Rent Exceptions only if all of the following are true:

- The HOME rent limits do not support the continued financial viability of the property;
- The property's serious financial distress is due to conditions which were unforeseen or beyond the control of the owner;
- Other sources of financial relief have been pursued; and
- The exception rents are the minimum required to maintain continued financial viability of the property.

NOTE: See Notice CPD-94-20, issued July 25, 1994.

For properties with multiple forms of governmental assistance, sponsors must consider the requirements of all assistance programs when setting rents. For example, if Low Income Housing Tax Credits are used by the property, the property must comply with LIHTC rent requirements as well as those under the HOME program. See the HOME model, *Using HOME with Low Income Housing Tax Credits*, November, 1998

Reductions in Maximum HOME Rents

If the Fair Market Rents and/or area median incomes decline, the maximum HOME rents may decline as well. However, regardless of changes in Fair Market Rents and area median incomes over time, sponsors are not required to lower the rents for HOME-assisted units below the HOME rents in effect at the time of project commitment.

Fixed and Floating Units

For properties with both HOME-assisted and non-assisted units, the program adminstrator or property owner must select "fixed" or "floating" units at the time of project commitment.

- **Fixed** – When HOME-assisted units are "fixed," the specific units that are HOME-assisted (and, therefore, subject to HOME rent and occupancy requirements) are designated and never change. Properties where all of the units are HOME-assisted are automatically "fixed."
- **Floating** – When HOME-assisted units are "floating," the units that are designated as HOME-assisted may change over time, as long as the total number of HOME-assisted units in the project remains constant. The floating designation gives the owner some flexibility in assigning units. If the floating designation is used, the owner must ensure that the HOME-assisted units remain comparable to the non-assisted units over the affordability period in terms of size, features, and number of bedrooms.

A tenant's income is likely to change over time. If changes occur during the affordability period, the owner must take certain steps to maintain compliance with HOME rent and occupancy requirements. The project must maintain the correct number of High and Low HOME Rent units. Rents must be adjusted for tenants whose incomes rise above 80 percent of the area median income.

The Income Eligibility Requirement – 24 CFR §92.216

The Program Rule and the Project Rule

Rental housing and tenant-based rental assistance funded by a participating jurisdiction in each *allocation year* must comply with an income eligibility "Program Rule." The Program Rule requires that at least 90 percent of the initial resident households must have *gross incomes* at or below 60 percent of median income (adjusted for household size). For example, if a city funded three HOME-financed rental housing properties in its 1997 allocation year, 90 percent of the original resident households across all three properties must have incomes at or below 60 percent of area median.

The remaining households must have gross incomes at or below 80 percent of median income (adjusted for household size).

The Program Rule applies to the initial resident households. As residents move out, the "Project Rule" governs rents and eligibility for subsequent residents.

The Project Rule has two provisions:

- All households residing in HOME-financed units must have gross incomes at or below 80 percent of median; and
- In addition, for properties with five or more HOME-assisted units, at least 20 percent of households must have gross incomes at or below 50 percent of median.

The Adjusted Income Determination

There are two situations in which the household's rent is based directly on the household's income:

- *Over-income households* whose gross income exceeds 80 percent of median. Rent determination for over-income households is discussed later in this chapter.
- *Certain Low HOME Rent households* if the sponsor chooses to base the Low HOME Rents on actual household incomes (the second of the two allowable methods for setting Low HOME Rents discussed earlier in this chapter).

Like other HUD programs, the HOME Program uses gross incomes for eligibility purposes and adjusted incomes for rent determination purposes. Adjusted household income uses the adjustments published at 24 CFR §5.611, including the adjustments shown below.

The Initial Income Certification Requirement – 24 CFR §92.203(b)

Household incomes must be determined at the time of move-in. Each item of income must be verified. The HOME Program allows participating jurisdictions to use one of the following three definitions of "annual income" (i.e., gross income for eligibility purposes):

- *The HUD Section 8 definition* (found at 24 CFR §5.609). This is the definition used in most HUD programs. Sponsors who utilize Low Income Housing Tax Credits should note that the Section 8 definition requires verification of all household financial assets, even if the total amount is less than $5,000.
- *The Census Long Form definition*. This is the definition used in the last decennial census.
- *The IRS adjusted gross income definition*. This is the definition used for reporting individual taxable income to the IRS.

The HOME model *Technical Guide for Determining Income and Allowances for the Home Program* contains a thorough discussion of income determination and verification. In general, third party written verification is preferred, with the verification being sent directly from the third party (employer, benefit provider, etc.) to the property.

The Annual Recertification Requirement – 24 CFR §92.252(h) and (i)

In general, household incomes must be redetermined annually. The recertification must use the same definition of income as the initial certification. Sponsors are always permitted to base the recertification on a review of actual source documents (the same method as the initial certification). However, the participating jurisdiction may permit one or both of these additional recertification methods:

- **Resident Statement and Certification.** Residents may make a written statement of the amount of the family's annual income and family size along with a certification that the information is complete and accurate. The certification must state that the family will provide source documents upon request.
- **Government Means Test.** A written statement from a government agency that provides benefits to the family and that examines the family's annual income each year. In addition to indicating the family size, the statement must indicate the family's annual income or indicate the dollar amount of the applicable HOME income limit and state that the family's annual income does not exceed that amount.

If the participating jurisdiction permits the first method above and the sponsor uses that method, then for properties with affordability periods of more than five years, all resident households must be recertified during the 6th year of the affordability period (and, where applicable, the 12th year, 18th year, and so forth) based on direct review of actual source documents.

If a household's current annual income exceeds the eligibility limit, the unit continues to qualify as affordable housing, so long as the owner fills the next available unit with an eligible household. The HOME Program defines *next available unit* as the next unit of similar or larger size. Sponsors who use the Low Income Housing Tax Credit program should note that the HOME next available unit definition differs from the definition used in the LIHTC program.

Households that Are Over-Income at Recertification

If a household's annual income at recertification exceeds 80 percent of the area median, the household's rent may be increased. Tenants in HOME-assisted fixed units must pay the lesser of the amount payable by the tenant under state or local law or 30 percent of the household's adjusted income. However, tenants of HOME-assisted units that have been allocated Low Income Housing Tax Credits by a housing credit agency pursuant to Section 42 of the Internal Revenue Code of 1986, must pay rent governed by Section 42. See the discussion of adjusted income vs. gross income earlier in this chapter. See also 24 CFR §92.252(i)(2). Where state or local law imposes rent controls, the rent control applies.

Over-income tenants in floating unit projects must pay 30 percent of their adjusted income for rent and utilities; however, the rent may not exceed the market rent for comparable, unassisted units in the neighborhood. The unit occupied by the over-income tenant is no longer considered to be HOME-assisted, and the next available unit in the project of comparable size or larger must be rented to a HOME-assisted household.

As with all other rent setting decisions, sponsors with multiple forms of governmental assistance must comply with the rent restrictions under all of the property's assistance programs. In particular, sponsors using the Low Income Housing Tax Credit may not exceed the LIHTC maximum rents for residents whose incomes exceed the HOME eligibility limits. Under the LIHTC program, the tenant's rent is not adjusted and the unit does not need to be replaced by another comparable unit until the tenant's income rises above 140 percent of the LIHTC program eligibility threshold.

Households that Change from Low to High at Recertification

Low HOME Rent households must have initial incomes at or below 50 percent of median. If the income of a tenant occupying a Low HOME Rent unit increases, but does not exceed 80 percent of area median income, that unit becomes a High HOME Rent unit. To replace the Low HOME Rent unit, the next available unit must be rented. Subject to the terms of the lease, the rent of the initial tenant whose income has increased may be increased to the High HOME Rent for the unit. This process should not increase the number of HOME-assisted units.

Households that Change from High to Low at Recertification

High HOME households must have initial incomes at or below 80 percent of median (or 60 percent of median for most original residents, as provided in the Program Rule discussed at the beginning of this chapter). Sometimes, at recertification, household income has decreased to 50 percent of median or below. If this occurs, the sponsor may choose to reduce the rent to not more than the Low HOME Rent limit, in which case the sponsor may now count the household as a Low HOME household.

Compliance Requirements Affecting Operations

The Period of Affordability Requirement – 24 CFR §92.252(e)

Depending on the amount of HOME assistance, the property must maintain compliance with HOME Program affordability requirements for between five and twenty years. These requirements carry rent and occupancy restrictions for varying lengths of time, depending on the average amount of HOME funds invested per unit and the type of HOME-funded activity.

Rent and Occupancy Restrictions		
Activity	Average Per-Unit HOME Funds	Minimum Affordability Period
Rehabilitation or Acquisition of Existing Housing	Less than $15,000 per unit	5 years
	$15,000 to $40,000 per unit	10 years
	More than $40,000 per unit	15 years
Refinance of Rental Housing	Any amount	15 years
New Construction of Rental Housing	Any amount	20 years

HOME affordability periods are minimum requirements. Participating jurisdictions may establish longer terms of affordability for their programs.

Nondiscrimination Against Voucher Holders – 24 CFR §92.252(d)

Owners of HOME-assisted rental units may not refuse to lease to any household on the basis that the household receives assistance under voucher or certificate programs.

Prohibited Lease Provisions – 24 CFR 92.253(b)

The lease between the owner and tenant in a HOME-assisted property cannot contain any of the following provisions:

- **Agreement to be sued** – Agreement by the tenant to be sued, to admit guilt, or to a judgement in favor of the property owner in a lawsuit brought in connection with the lease.
- **Agreement regarding treatment of property** – Agreement by the tenant that the owner may seize or sell personal property of household members without notice to the tenant and a court decision on the rights of the parties. This provision does not apply to the disposition of personal property left by a tenant who has vacated the property.
- **Agreement excusing owner from responsibility** – Agreement by the tenant not to hold the owner or the owner's agents legally responsible for any action or failure to act whether intentional or negligent.
- **Waiver of notice** – Agreement of the tenant that the owner may evict the tenant or household members without instituting a civil court proceeding in which the tenant has the opportunity to present a defense or before a court decision on the rights of the parties.
- **Waiver of a jury trial** – Agreement by the tenant to waive any right to a trial by jury.
- **Waiver of right to appeal a court decision** – Agreement by the tenant to waive the tenant's right to appeal or to otherwise challenge a court decision in connection with the lease.
- **Agreement to pay legal costs, regardless of outcome** – Agreement by the tenant to pay attorney's fees or other legal costs, even if the tenant wins in a court proceeding by the owner against the tenant. The tenant, however, may be obligated to pay costs if the owner wins.

Affirmative Marketing – 24 CFR §92.351

HOME requires affirmative marketing for all properties of five or more units. These properties must prepare and submit for approval by the participating jurisdiction an Affirmative Fair Housing Marketing Plan (HUD Form 935.2 is a useful way to organize and submit this information, but the form is not required by the HOME Program). Affirmative marketing steps consist of actions to provide information and otherwise

attract eligible persons in the housing market area to the property without regard to race, color, national origin, sex, religion, familial status, or disability. Owners should display the Fair Housing logo on site as well as in any printed literature or signs.

Property Standards Requirements – 24 CFR §92.251

HOME-financed rental housing must meet the following physical standards throughout the period of affordability:

- **Construction and rehabilitation** – Compliance with all applicable state and local codes, standards, and ordinances. Newly constructed properties must also meet the Model Energy Code. If there is no applicable local building code, participating jurisdictions may select from several national codes;
- **Acquisition of existing housing** – Compliance with state and local housing quality standards or codes. If there is no applicable local code, the property must comply with HUD's Section 8 Housing Quality Standards (24 CFR §982.401);
- **Accessibility** – Compliance with HUD's regulations implementing Section 504 of the Rehabilitation Act of 1973. "Covered multifamily dwellings" (as defined at 24 CFR §100.201) must also meet the Fair Housing Act's design and construction requirements (see 24 CFR §100.205); and
- **Ongoing Maintenance** – Compliance with all of HUD's housing quality standards in 24 CFR 982.401. The participating jurisdiction will conduct periodic inspections, the frequency of which will be determined by the number of units in the property. See "Tools for Compliance Reviews by Participating Jurisdictions," below.

Common HOME Compliance Issues

Some of the more common compliance issues in the HOME Program include:

- **Rent setting –** Errors include failure to use the most recently published data from HUD, inaccurate utility analyses, and failure to stay in compliance with both the High and Low HOME Rent Limits.
- **Income verification** – Failure to maintain adequate documentation of residents' incomes.
- **Income determination** – Excluding income items that HOME requires to be included in the calculation of resident household income.
- **Minimum property standards** – Failure to maintain the property in compliance with applicable property standards.

At 24 CFR §92.253, the HOME Program includes a number of requirements for the property's standard lease agreement, lease enforcement, and resident selection.

Tools for Compliance Reviews by Participating Jurisdictions

Site inspection – A visit to the property allows the participating jurisdiction to see for itself whether the property is meeting community expectations. The number of units in a property will determine the frequency of required on-site inspections. Inspections are performed annually for projects of 26 or more units, every 2 years for projects of 5 to 25 units, and every 3 years for projects with 1 to 4 units. Inspectors should talk with residents and neighbors, as well as with management staff. A typical physical inspection will encompass at least:

- building exteriors, looking in particular for water infiltration problems, deteriorating paint, and units that appear vacant but are not listed as such;
- grounds;
- recreational facilities;
- the office, maintenance shop, and public restrooms;
- all units listed as vacant. This allows the inspector to evaluate management's process for making vacant units ready to rent. It also evaluates the accuracy of management's list of vacant units, and management's reports regarding the condition of those units; and
- a sample of occupied units. It is important to visit occupied units in order to evaluate whether residents are receiving the maintenance service to which they are entitled. In particular, the inspector should check for health and safety issues such as missing or

non-functioning smoke detectors, debris stored in mechanical closets, and plumbing problems and evidence of water damage.

In order to inspect occupied units, it will be necessary for management to announce the inspection several days in advance so as to give residents sufficient advance notice in accordance with the lease agreement.

File review – The participating jurisdiction should review a sample of resident files with significant activity since the last review: move-ins, unit transfers, and recertifications. The participating jurisdiction will want to check that:

- Management is using correct High and Low HOME Rent Limits;
- Management is using correct estimates for resident-paid utilities;
- Each item of income is supported by acceptable verification;
- Each item of income was reflected accurately in the eligibility calculation. In particular, verify that hourly/weekly/monthly income was properly annualized; and
- Each deduction or allowance is supported by acceptable verification.

Interaction of HOME with Other Financial Assistance Programs

HOME-financed affordable rental housing will often receive financial assistance from other governmental programs as well. Examples include the Low Income Housing Tax Credit program, state affordable housing finance programs, and HUD's Section 8 rental assistance program.

Sometimes, HOME requirements will appear to conflict (or may actually conflict) with requirements under another program. Sponsors are advised to seek appropriate expert advice during the design and financing process to identify any potential conflicts between assistance programs. Sponsors are also advised to seek resolution of these conflicts prior to beginning the development process itself.

Chapter 4

Introduction to Intervention

Asset managers and property managers must intervene when things go wrong. Experienced managers intervene well before things go wrong.

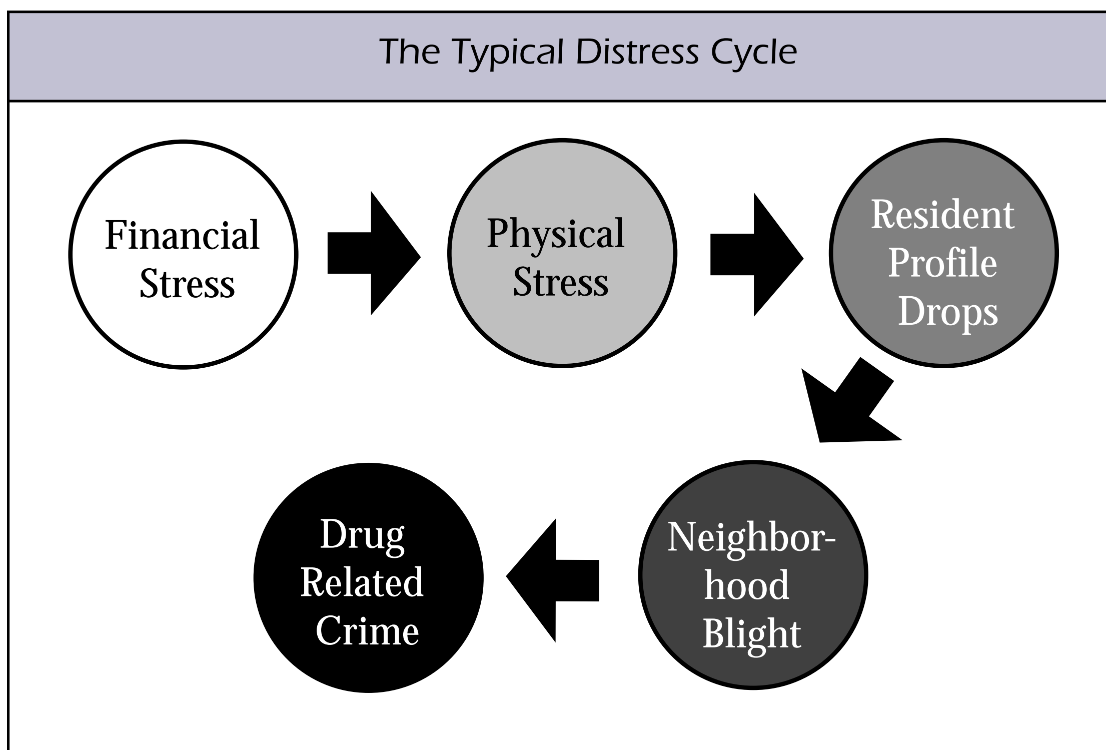
The Distress Cycle

Experienced managers have learned that a typical severely distressed property spends several years moving from stability to chaos. By intervening early in the *distress cycle*, managers can make relatively lower-cost interventions and can avoid the more severe types of distress. That's the good news.

The bad news is that the outbreak of drug-related crime in the late 1980s has dramatically decreased managers' flexibility in dealing with stressed multifamily properties. By speeding up the distress cycle, the drug-related crime epidemic has made it more essential to intervene early in the cycle.

In the 1970s, managers knew that properties could survive several years of financial belt-tightening. During that time, inflation would drive up the property's market rents, debt service payments would stay the same, and cash flow would recover. Although the property's exterior appearance, called *"curb appeal,"* would suffer for a few years and although the property wouldn't keep up with its competitors, as a general rule, there wouldn't be lasting harm to the property. These rules of thumb no longer work, especially in affordable rental housing:

- *We are now in a low-inflation economy*. Managers can no longer count on inflation to bail properties out of bad underwriting or bad luck.
- *We have drug-related crime.* Drug dealers look for properties that send the message "the owner doesn't care, and residents don't care."
- *Drug dealers move quickly*. Even a year or two of financial belt-tightening may result in an outbreak of drug-related crime. A penny



saved in belt-tightening can cost a dollar or more in anti-crime efforts.

Let's review the stages in the distress cycle:

- **Financial stress** – For whatever reason, the property is not generating its projected Net Operating Income. Perhaps the local market is weak, and the property has a vacancy problem. Perhaps the marketing plan isn't working. Perhaps utility costs, real estate taxes, or payroll costs are considerably higher than projected. The owner is faced with a number of unpleasant alternatives:

  — Inject cash into the property (possibly throwing good money after bad);

  — Divert debt service funds into needed operational expenses (triggering a *mortgage default* and thereby risking loss of the property by *foreclosure*); or

  — Squeeze operating expenses down to what the property can afford.

It is very tempting to choose the third alternative.

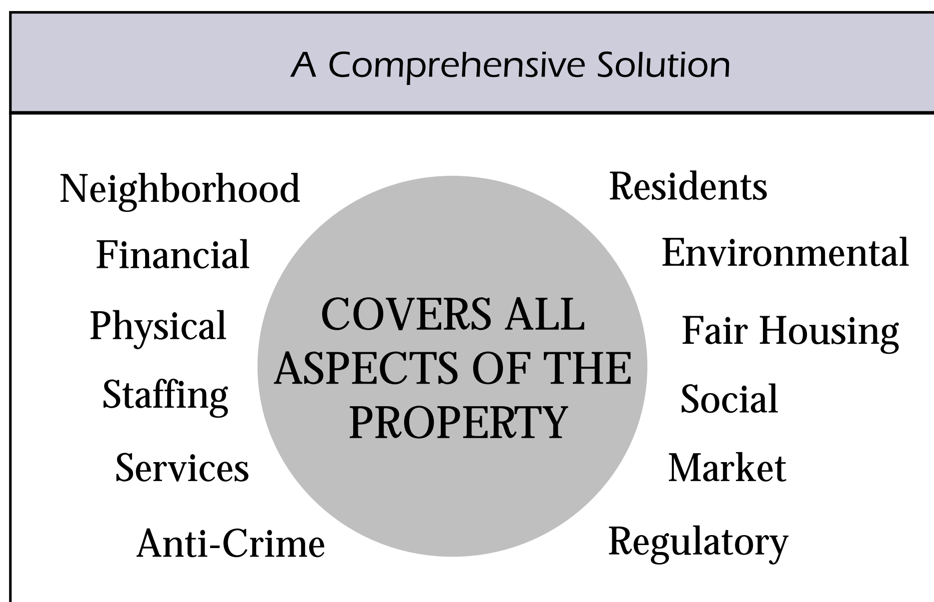
- **Physical stress** – The easiest way to squeeze operating expenses is to cut corners on maintenance. Carpets are dyed rather than replaced, vacant apartments get a little touch-up paint instead of a full repaint, the grass goes three weeks between mowings instead of one week.

- **Resident profile drops** – As the property becomes less attractive, good residents move out because they have better choices. Desirable applicants either do not visit the property or do not apply after they see it, again because they have better choices. This leaves the property with residents and applicants who can't find better housing, probably because they would have trouble passing better properties' resident selection criteria.

- **Neighborhood blight** – The property's physical and resident-profile deterioration begins to be exported to neighboring properties, partly because this property's problems prevent neighboring properties from commanding optimum rents and selling prices, and partly because prospective renters and buyers are discouraged from living in the neighborhood.

- **Drug-related crime** – Now the neighborhood starts to look like a good place to conduct drug-related criminal activity: marginal maintenance, marginal residents, probably the sort of neighborhood where no one will bother a drug dealer.

The anti-crime initiative is a specialized subject that is beyond the scope of this model. The short summary is "do what you can to avoid having this problem." Anti-crime initiatives are always expensive, always time-consuming, and frequently unsuccessful. As a result, today's experi-



enced managers avoid putting properties under financial and physical stress; rather, they attack the underlying problem, even if it means a painful financial restructuring of the property. Better to preserve the property and incur financial pain, than to postpone action and incur a much larger loss, plus damage to the surrounding community.

Principles for Intervention

As discussed above, the first principle is *intervene early in the distress cycle*. One important tool is to develop *early warning systems* that help asset managers identify properties that are in the early stages of developing problems. Some early warning systems are primarily financial: examples include property performance versus budget and the property's multi-year financial plan. Other early warning systems are primarily non-financial: examples include monitoring the economic health of the local economy and monitoring the social health of the surrounding neighborhood.

Asset managers spend most of their time on the top and bottom ten percent of their properties.

Expert managers conduct a *comprehensive analysis* that takes into account all relevant aspects of a failing property. For affordable rental housing, comprehensive analysis will cover a wide variety of topics:

This is not to say that intervention should wait until the analysis is completed, just that it is premature to agree on a solution before understanding all of the relevant aspects of the problem.

Part of the comprehensive analysis process is a *search for resources*. Too often, asset managers assume that only one party can bring resources to the table. More careful analysis will often turn up additional resources, sometimes in unusual places.

If there are crime problems, *re-establish personal security*. No other part of the solution is likely to work unless progress is being made against the crime problem.

In affordable rental housing, *involve residents in the solution*. This lesson is often learned the hard way. The more serious the problem, the more important resident participation becomes.

In designing solutions for troubled properties, *avoid half measures*. Problem properties are almost always more troubled than they appear, and therefore the needed solution is almost always more intensive than the initial analysis will indicate. Experienced managers always assume that the problem is somewhat worse than it appears to be, and they over-design their solutions accordingly.

The "Triage" Concept

Triage is a medical term for the process of deciding which emergency room patients receive immediate care. To simplify a very complex process, those patients who will die whether they receive immediate care or not are moved to one side. Similarly, those who will live whether they receive immediate care or not are moved to another side. The patients who remain are those who will live or die depending on whether they receive care now.

This is not to imply that housing managers make the same sort of split-second life-or-death decisions as emergency room triage officers. However, the triage concept is useful in property management and asset management because it helps us decide how to allocate scarce resources of expertise, time, and money.

Here is one example of a triage strategy: asset managers who work for property owners typically divide properties into three categories:

- **High value** – Properties that have the potential for lucrative sale or refinancing transactions.
- **Problems** – Properties that have the potential to become problems if action is not taken now.
- **Everything else** – The remaining properties probably do not need asset management attention until something changes.

As a result, these asset managers spend most of their time on the top and bottom ten percent of their properties. Typically, the director of asset management for the owner will limit the asset management department to the minimum staff needed to work the high value and problem properties intensively and give the remaining properties relatively minimal attention.

Strategies for Success in Intervention

A clear understanding of the HOME Program regulations will help alleviate potential problems. If during a monitoring visit or any time during the period of affordability, the participating jurisdiction reports a "finding of non-compliance" most HOME agreements will state the amount of time given for the "right to cure." If the time period given to resolve the compliance issue is not sufficient to correct the deficiency, most participating jurisdictions will work with owners to determine a schedule the owner will need to follow in order to bring the property back into HOME compliance. If the problem is not resolved, the owner may face paying back all of the HOME funds immediately to the participating jurisdiction. Strategies for preventing and resolving problems include:

Clarify standards – Many problems arise simply because someone didn't understand what the rules were. Conversely, good standards (with clear and objective measurements) almost always result in improved compliance and fewer problems. Of course, standards must be reasonable and should be directly related to key objectives.

Clarify consequences – Experienced managers have learned the hard way that being clear about expectations is helpful but not sufficient: it is also necessary to be clear about the consequences of failure to meet expectations. It is also important for everyone to understand that sanctions become progressively (and predictably) more severe if non-performance is not cured promptly. Of course, fairness requires that all sanctions incorporate the key elements of due process:

- **Materiality** – Powerful sanctions must be reserved for non-trivial violations.
- **Notice** – Before sanctions are applied, the party being sanctioned should receive written notice in enough detail to communicate the problem clearly.
- **Cure** – If the violation can be cured, the process should allow a reasonable period for the violator to fix the problem.
- **Appeal** – Interventions often give rise to disputes about whether a violation has occurred, whose fault it is, and whether the requested actions are reasonable and proper. An expert but neutral party should be available to hear these disputes and resolve them.

Know what the problem is – Some interventions are required for financial reasons (the preceding discussion of the distress cycle is an example). Other interventions are required because property management or asset management is not performing as it should. Examples include:

- intervention by the owner's asset manager to replace a non-performing property manager;
- intervention by a participating jurisdiction because of failures to meet the compliance requirements of the HOME Program; and
- intervention by a lender's asset manager because the owner has failed to comply with the loan requirements.

Know desired outcomes – Interventions typically involve competing objectives, especially in affordable housing. It is important to take the time to decide how to balance competing objectives before launching the intervention. This is not the same as knowing how to solve the problem—something that won't be known until well into the intervention process. Before beginning the intervention, however, it is important to know what outcomes are acceptable and unacceptable.

Communicate clearly – Make sure the other affected parties know what the problem is, the results wanted, when action should occur, and the consequences of inaction (or inadequate action). It is important to communicate in enough detail that other parties can respond. Owners who fear that their properties may be out of compliance and are having difficulty resolving the problem, should contact the participating jurisdiction with whom they have a HOME agreement. The participating jurisdiction can often provide guidance and referrals to help the owner correct the problem.

Force the pace – Interventions are not a "business as usual" situation. Don't allow the process to drag on, particularly not in your own organization. Conversely, setting unreasonably short timeframes will make the problem worse.

Meet face to face – Intervention is tricky. As a general rule, interventions are more likely to succeed when the affected parties begin candid, face-to-face communication early in the process.

Focus on results – Be flexible about how the results get achieved. Avoid the temptation to get sidetracked by issues of personality.

Use interest-based negotiating techniques – The easiest way to resolve interventions is to identify concessions that each party can make easily but that have disproportionately high value to the other parties. Understanding the other parties' interests, resources, and limitations is a good first step. A good second step is finding objectives that are shared by two or more parties.

Escalate if the response is unsatisfactory – If reasonably satisfactory action does not occur, impose sanctions (i.e., the consequences you discussed in your initial communication) and outline the further (and more intensive) sanctions that will occur quickly if reasonably satisfactory action still does not occur.

Treating the Property as a Stakeholder

Often, interventions become arm-wrestling matches between two parties: a regulatory agency and an owner, an owner and a property manager, or a lender and an owner. Treating the intervention as solely a two-party exercise leaves out the other interested parties—in affordable housing, those interested parties will almost always include the owner, the manager, the lender, the regulatory agency, the residents, and the local community.

However, the preceding list leaves out one interested party that is often sacrificed in interventions: the property itself. Before agreeing to a solution, parties to an intervention should ask themselves "will this solution result in the property's ongoing financial viability, physical viability, and affordability?" Often, the answer will require the parties to go back to the drawing board and work some more on the solution. The reason is that *everyone except the property often can live with a solution that works in the short run but fails in the long run*.

In the Native American medicine wheel tradition, decisions are made only after hearing from all viewpoints represented on the medicine wheel. One of those positions is the "Dog Soldier," who speaks on behalf of "the children's children." The analogue for affordable rental housing is that someone must speak on behalf of the property as it will exist 20 years from now, the people who will live there 20 years from now, and the people who will live elsewhere in the neighborhood 20 years from now.

We will now consider some typical intervention situations.

Financial Intervention to Restructure an Over-Leveraged Property

One of the most common intervention situations involves a property that is physically sound, competently operated, in compliance with its affordability objectives, but having trouble paying its bills. Sometimes the problem is exclusively financial:

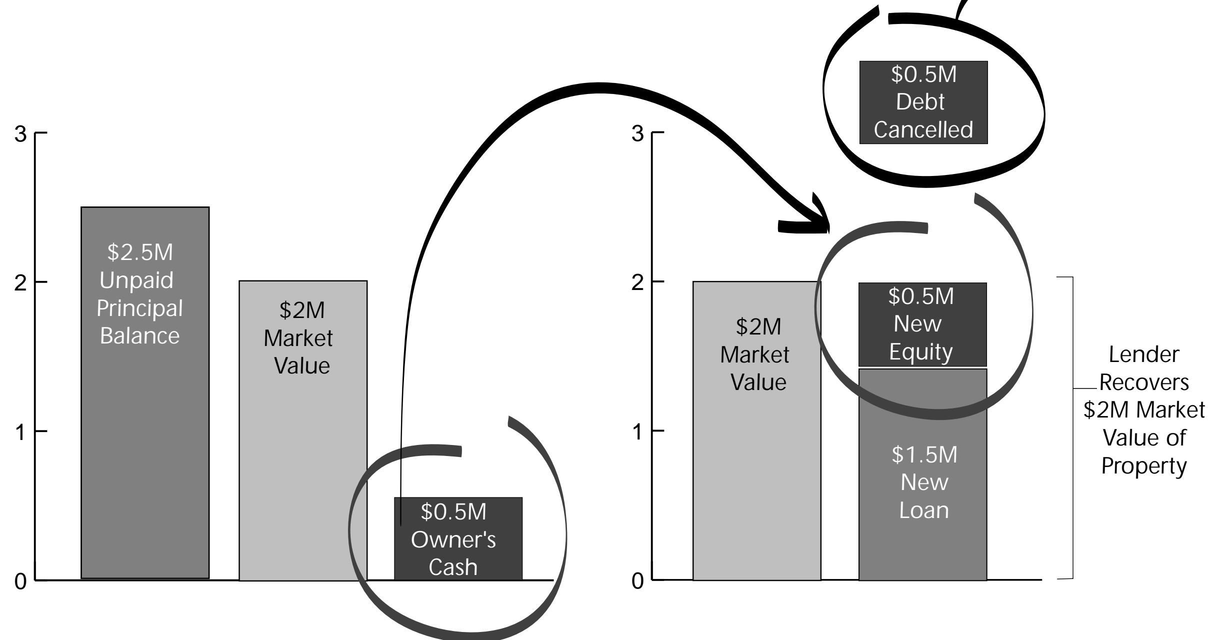
- The sponsors were too optimistic in their original financial projections, and the property's Net Operating Income is simply not enough to make required debt service payments.
- The sponsors incurred cost over-runs and borrowed additional money to cover the over-runs. The additional and unanticipated debt service costs are more than the property can support.
- The property suffered a major increase in utility costs, real estate taxes, or property insurance, and the property's Net Operating Income is too low to cover the mortgage payment.
- The mortgage loan has an adjustable interest rate that has risen beyond the levels that the property can afford.
- The original mortgage loan came due and had to be refinanced at a much higher interest rate than the property can afford.

In these purely financial problem situations, the property's *market value* typically will be less than the *unpaid principal balance (UPB)* of the mortgage loan (an *over-leveraged property* and an *under-collateralized mortgage loan*). The *loan workout* that resolves the problem frequently will be purely financial. Loan workouts always involve painful financial consequences for both the lender and the owner. Examples of workout approaches include:

- **The owner loses the property** – Sometimes the lender assumes ownership of the property, either with or without the owner's cooperation. Sometimes the lender takes possession under a *foreclosure* process, in which a court awards full title to the first mortgage lender and, in the process, erases all other debts of the property (*junior liens*). Sometimes the owner voluntarily gives possession to the lender, under a *deed in lieu of foreclosure* (in which the lender takes over the owner's

Sample Resolution for a Troubled Property

In this sample resolution, the owner has paid $500,000 to the lender and the lender has forgiven $500,000, thereby reducing the Unpaid Principal Balance to $1.5 million, an amount the property can service. The lender has covered the market value of the property ($2 million) with the new $1.5 million loan, and the $500,000 cash payment from the owner. Both parties benefit, and both parties incur losses, but the property survives.



interest in the property but leaves the junior liens in place). The lender then resells the property to recover a portion of the unpaid principal balance.

- **The owner sells the property –** Sometimes the property is sold to a new owner. The proceeds of the sale typically are somewhat less than the unpaid principal balance of the loan and are paid entirely to the lender.
- **The lender accepts a reduced loan payoff –** The owner offers to make a cash payment that is less than the unpaid principal balance, and the lender accepts this *discounted payoff offer* because the lender determines that doing so is financially superior to the lender's other options (such as pursuing foreclosure).
- **The lender modifies the loan –** Rather than immediately pursuing a partial payoff of the loan, sometimes the lender will agree to modify the terms of the mortgage loan, reflecting the lender's judgment that working with the borrower will result in a reduced loss to the lender. The lender might reduce an above-market interest rate to market levels, extend the loan term, allow the borrower to make interest payments only, or allow the borrower to make partial interest payments and *accrue* the remaining interest. The borrower typically makes financial concessions also. These might include: agreeing to make an immediate cash payment to the lender, agreeing to reduce the prices that affiliates of the borrower (such as property management companies or maintenance contractors) charge to the property for professional services, or agreeing to share any future profits with the lender.
- **The lender accepts a partial payment and modifies the loan –** For example, suppose that the unpaid principal balance is $2.5 million at 8.5 percent with 25 years remaining but that the market value of the property is only $2 million. The maximum loan that the property could support under current mortgage market conditions is $1.5 million at 7.5

percent with a 30-year term. The loan work-out might involve the owner making a $500,000 cash payment to the lender and the lender reducing the unpaid principal balance to $1.5 million, reducing the interest rate to 7.5 percent and extending the loan term to 30 years. The lender would therefore recover the $2 million market value of the property (the owner's $500,000 cash payment plus the modified, and viable $1.5 million mortgage loan) without incurring any foreclosure costs. The owner would retain ownership of the property and its new $500,000 investment would be economically sound. The lender would incur a $500,000 loss, and the owner would recognize the loss of its original equity investment. Under this structure, it is as if the lender foreclosed and resold the property, at market value, to the existing owner, only without the expense, risk, and delay of an actual foreclosure process. Both parties benefit, both incur large losses, and in the process the property emerges with sound financing.

Financial interventions require high quality financial analysis, willingness to be objective about issues that have painful financial consequences, and skill in negotiation. Financial restructuring is one of the most expertise-intensive aspects of asset management and property management. Accordingly, most lenders utilize workout specialists rather than their regular loan officers. Similarly, owners often engage their own workout specialists as well.

Non-Financial Intervention

Perhaps more commonly, there are non-financial dimensions to the problem. Sometimes these non-financial problems are obvious. In other instances, the non-financial issues are discovered during the comprehensive analysis:

- **Property management effectiveness** – More often than not, the owner or lender or both will suspect that the property management company is not as effective as it could be. Sometimes this is a purely human tendency to divert blame onto third parties, and

A Hard Luck Story

A city housing director tells a hard luck story: "This CHDO was doing just great. We really liked their people. They were upbeat and confident, they worked hard, and they could make things happen. They were very cost-efficient. They agreed to very small developer fees, and then they ended up putting most of those fees back into the properties to cover cost overruns and unexpected start-up costs. They had a string of five or six successful affordable rental housing developments—newly constructed, attractive housing that fit right into the neighborhood, fifty to seventy-five units or so. Then they came to us with a very creative proposal to rehab and redevelop an entire downtown block that was largely vacant. The redevelopment would have retained the existing building facades, with retail on the first floor, affordable rental housing on the second and third floors, plus a small inn and restaurant. We loved it, especially because this area of the city was one of our major priorities. Even better, these folks didn't want nearly as much money as the for-profit developers. They got site control and did some fantastic negotiating. Things were really looking good, but the next thing I knew they couldn't meet payroll. Then they just sort of came apart at the seams. I'm disappointed and angry, and I can't even figure out who to be angry at!"

What happened? The CHDO simply ran out of cash. They certainly weren't pocketing any developer fees, so they were facing real problems covering their overhead costs. In all likelihood, their existing portfolio had cash flow problems also. Those existing financial stresses probably required the CHDO to completely exhaust its emergency funding sources, leaving the organization extremely vulnerable to any new piece of bad financial news. In this precarious financial condition, the CHDO decided to attempt a large redevelopment project. Any such project requires very significant cash outlays for predevelopment costs. Although these costs should be recovered during the development process, the necessity to fund them up front and carry them for a period of several months requires significant financial strength. The combination of existing financial stress plus large predevelopment costs for a new project was too much for the thinly capitalized CHDO to handle.

sometimes there really are effectiveness problems. Often as a result, the property management company will be replaced as part of the intervention resolution. Sometimes the new property management company will improve property performance and sometimes it will not.

- **Owner effectiveness** – The lender (and/or the regulatory agency) will sometimes suspect that the property owner is not paying enough attention to the property. In extreme cases, the owner may be suspected of actively harming the property through willful noncompliance with lender or regulatory requirements, or by diverting to its own pockets money that was needed for property expenses. In these situations, the lender/regulatory agency will push for solutions that separate the owner from the property, as opposed to solutions that leave the owner in place.
- **Non-housing services** – The resident population needs more intensive non-housing services than the sponsors anticipated, and the additional service costs are stressing the property's operating budget. Typically, the lender will regard this as the owner's problem and will insist that the owner either discontinue the additional services or fund them from a source other than the property's rents.
- **Drug-related crime** – Anti-crime costs are stressing the budget. Typically, the lender and owner and property management company will have a vigorous discussion about whether the crime problem was preventable, whether the anti-crime measures are effective, and whether the anti-crime measures are the lowest-cost approach to combatting the crime problem.
- **Long-term capital needs** – The property's Replacement Reserve fund is not adequate to meet the property's capital expenditure needs. Typically, this issue is analyzed by means of a capital needs assessment, usually performed by an expert third party because the presence of a neutral expert helps the parties to resolve contentious issues such as remaining useful lives of existing components.
- **Environmental issues** – Property components that were acceptable at the time of development may require environmental remediation as a result of changes in laws or regulations. Two examples are: underground fuel storage tanks that were not considered problematic until the 1990s; and lead-based paint that was in general residential use until 1978.

Interventions that combine financial and non-financial issues are especially complicated. Lenders, regulatory agencies, owners, and property managers will generally apply their best talent (either in-house or third party) to these situations.

Developer Failure

Just as affordable rental housing properties can experience financial disaster, so can their developers and owners. Just as there are warning signs that a property is failing financially, there are also warning signs that a developer or owner is in financial trouble.

Failure after development completion – Participating jurisdictions will always be affected when the owner of one or more HOME-financed properties fails. Someone has to make sure that the properties continue to provide affordable housing, continue to comply with HOME requirements, and continue to be operated day to day. Sometimes these essential tasks fall through the cracks when the owner is fighting for financial survival. When a developer fails, the participating jurisdiction's asset manager should become particularly proactive to make sure that the properties and their residents do not suffer.

Failure during development – When a developer fails *during* the development process, the situation is much more difficult. The failure of a general contractor can be equally problematic. Because solving this sort of problem during development is so difficult, participating jurisdictions must take great care to do business with strong and capable partners.

Failure during pre-development – Developer failure during the pre-development process can also be a significant problem, especially if the participating jurisdiction has advanced pre-development funds.

Proactive Asset Management

As with failing properties, when a developer is failing, successful asset managers intervene early. However, in order to intervene early, the participating jurisdiction's asset manager has to be able to detect the warning signs of financial

stress. A hypothetical example will illustrate how a participating jurisdiction might determine whether a developer is in trouble and what sorts of interventions might be successful.

Early Warning Signs of Developer Failure

Let's take another look at the city housing director's hard luck story *(inset, page 53)*, which contained some warning signs:

- **Aggressive projections** – Because the developer accepted very low potential development fees during the underwriting and financing processes, there was little room for error.
- **Financially unsuccessful developments** – Although the developments were very successful socially and in terms of revitalizing the neighborhoods, they were unsuccessful financially. The potential developer fee (already small) either never materialized (due to cost overruns) or had to be reinvested in the property (due to excessive start-up costs).
- **Complexity** – The developer's track record of success was with properties that were exclusively affordable rental housing and exclusively new construction. The proposed property was mixed retail, hospitality, and residential as well as a rehabilitation property instead of new construction.
- **Scale** – The developer's track record of success was with small properties. They then took on a very large property.
- **Financial risk** – If a $3 million property has a 5 percent cost overrun, that's a $150,000 problem, enough to severely stress a small organization, and maybe enough to cause it to fail. If a $30 million property has a 5 percent cost overrun, that is a $1.5 million problem, too much for any small organization to survive.

Other warning signs that might have been discovered with a bit of research include:

- **"Bleeders" in the existing portfolio** – Whether the development process is profitable is one question. Equally important is whether the property can be operated profitably. Developers frequently have one or two properties that cannot cover their operating costs, debt service, and capital expenditure reserves. Most developers attempt to cover the shortfall, by deferring expenditures, by deferring payment of expenses, or by contributing cash to the failing properties. If the developer has sufficient financial strength and the properties recover (generally by increasing rents), the developer can survive this sort of problem. If the developer is financially weak or if the properties do not recover, "bleeders" can lead to the developer's financial failure.
- **Inability to cover overhead** – Clearly, the developer was not earning, collecting and retaining sufficient developer fees to cover its overhead (executive staff, developer staff, financial staff). Most nonprofit developers are unable to cover overhead through fund-raising, because most donors want to invest in tangible rather than intangible items. How, then, were those costs being covered? Most likely, from one of only a few sources: cash flow from the existing portfolio, borrowing from a bank, borrowing from an organizational sponsor, and diverting funds from predevelopment grants and existing properties.

Should the City Have Done More Up-Front Investigation of the CHDO?

As long as the developer continued to do small, new construction properties, only one or two at a time, the city would not necessarily have needed to engage in unusual preventive asset management. However, if the developer proposed to take on several small projects at once, the city might have taken more care. Similarly, if the developer proposed a large or particularly complicated project, the city would have been justified in obtaining additional verification of the developer's financial and organizational capabilities.

Because the CHDO proposed a large and particularly complicated project, the city might have followed one or more of these intervention strategies:

- Request a cash flow analysis of the CHDO's existing portfolio to establish whether the portfolio was healthy.
- Engage a qualified professional to analyze the CHDO's financial statement to establish:

— whether the organization's cash inflows were sufficient to cover its overhead and

— whether the organization was already excessively debt-burdened.

- Require the CHDO to bring in a financial partner to give the city greater assurance that the development team had the financial means to carry the project through to completion.

These modest interventions would probably have uncovered enough evidence of severe financial stress that the city would not have initiated significant new projects until the CHDO strengthened itself financially.

Should the City Have Done More Analysis of the Redevelopment Project?

Perhaps the redevelopment project was properly evaluated, properly structured, and was on track for success. However, in re-reading the hard luck story, it seems more likely that the city placed too much trust in the CHDO, and that the CHDO saw through "rose colored glasses" because of its own need to generate large sums of cash to solve its financial problems. This particular redevelopment project had an especially high risk of problems because:

- Estimating rehabilitation costs is more challenging than estimating new construction costs;
- Large projects typically have to be developed in stages that correspond with the ability of the local market to absorb the new product. Because of the longer time frame for development, a multi-stage project is inherently more risky than a smaller, single-stage project;
- Redevelopment activity alone is not always sufficient to revive a deeply troubled neighborhood. Often, deeper economic and demographic forces are at work;
- Owners of retail businesses usually want to see evidence of existing retail demand before investing in new stores. It would have been reasonable to expect a significant fraction of the retail space to remain vacant at least until most of the residential units were occupied; and
- Inns and restaurants are highly location-sensitive, and they fail at a higher rate than most other small businesses.

Accordingly, the city and the CHDO should both have done a great deal of investigation into the project's feasibility. Additionally, they should have attempted to reduce the high risk levels inherent in this type of project. At a minimum, the city might have:

- Commissioned its own independent analysis of the feasibility of the large redevelopment;
- Required the CHDO to partner with organizations that had sufficient experience with rehabilitation, retail, inns, and restaurants;
- Required the development team to post sufficient cash equity to support the project through a multi-year lease-up and stabilization period;
- Required the CHDO to bring in a financial partner with the capability to see the project through to completion;
- Provided operating funds to the CHDO (see §92.208(a) and §92.300(f));
- Provided predevelopment and seed money loans to the CHDO (see §92.301); or
- Conditioned its approval on firm commitments from experienced inn and restaurant operators to develop, own, and operate those parts of the project.

In Summary

Successful asset managers use early warning systems to spot properties that are fine now but are falling into difficulty. Successful asset managers intervene early in the distress cycle when a property is failing. As the discussion shows, these asset management tools are equally applicable to asset management of developers.

Conclusion
Achieving Operational Excellence

Everyone takes great pleasure at the ribbon-cutting and the grand opening. With operational excellence, everyone can also take pleasure in the successful long-term operation of each property in the portfolio. Over time, affordable rental housing can become one of the major success stories in each community, a source of civic pride for citizens and a source of organizational pride for developers, sponsors, and managers. Just as one dramatically unsuccessful property can "poison the well" for future affordable housing efforts, a series of conspicuously successful affordable rental housing properties can become a major source of community strength and vitality.

Operational Excellence as a Participating Jurisdiction

Pre-Development – When evaluating sponsors, participating jurisdictions should satisfy themselves that:

- Sponsors have a long-term commitment to the property and its neighborhood;
- The property's architectural design has been reviewed and approved by expert property managers and asset managers;
- Sponsors understand asset management issues and have a credible plan for operational oversight;
- The property's financing includes realistic projections of income, adequate allowances for operating expenses, and sufficient funding for the property's ongoing capital expenditure needs; and
- The proposed development is within the sponsor's demonstrated capabilities.

If the development budget does not include an adequate developer fee, the participating jurisdiction should make sure that the sponsor has other financial resources sufficient to cover its overhead.

Construction and Lease-Up – Ensuring that the sponsor has a plan for effective initial marketing and lease-up is important. If the construction schedule changes, or if the local rental market changes, the sponsor should rapidly adjust the marketing effort in response.

Early Warning Systems – Participating jurisdictions need to establish early warning systems to determine when properties are beginning to experience problems. These early warning systems will be based partly on the property's budgets, partly on operating data for similar properties, and partly on other factors influencing operations, including the health of the local economy and the health of the neighborhood rental housing market.

Normal Operations – Through periodic on-site reviews and other means, the participating jurisdiction must ensure that the property remains compliant with HOME regulatory requirements. The property must have a realistic operating budget. Property management should be operating the property in reasonable conformance to the budget. The sponsor should have a competent, written, long-term plan for the property. This long-term plan should include an assessment of future capital expenditure needs, updated every five to ten years.

Intervention – If the sponsor does not overcome problems quickly, participating jurisdictions should increase their asset management efforts in part to assure that HOME compliance does not suffer and in part to encourage the sponsor to resolve the problems before they become critical. If HOME compliance becomes unsatisfactory, the participating jurisdiction must step in to re-establish compliance.

Methods – The preceding tasks can be accomplished through a variety of methods. Some jurisdictions may want to rely primarily on asset management consultants; other jurisdictions may prefer to rely primarily on staff. All participating jurisdictions need early warning systems and oversight systems, but these systems can range from informal, paper-based systems to elaborate,

automated systems incorporating advanced technology. Some jurisdictions may want to employ an asset management expert to support the pre-development and financing specialists as well as the compliance and oversight specialists. Other jurisdictions may prefer to include asset management experts in each relevant department. Factors that may influence the choice of methods includes the volume of rental housing financed under the HOME Program, other rental housing activities needing similar asset management efforts, capabilities of existing staff, and the extent of known problems in the existing rental housing portfolio.

Examples – A small jurisdiction with a growing portfolio might engage a third party consultant to meet annually with developer/sponsors, conduct annual on-site compliance reviews, and advise the jurisdiction of any developing problems. This same consultant might also provide advice to the jurisdiction regarding the operational feasibility of proposed new developments. Conversely, a large jurisdiction that has financed affordable rental housing for many years will already have an asset management staff in place. Achieving operational excellence may require only modest efforts such as facilitating the participation of the asset management staff during the pre-development stage, implementing capital expenditure planning as part of the property budgeting process, and developing an improved early warning system.

Operational Excellence as a Sponsor/Developer

At each stage of development, participating jurisdictions can take steps to ensure operational excellence as a sponsor/developer. These steps are:

- **Pre-Development**
  - — Select a property management company with the expertise necessary to operate the property successfully.
  - — Involve operations experts in site selection, market analysis, choice of unit mix, and architectural design.
  - — Obtain detailed operating data for comparable properties for use in developing the revenue and expense projections.
  - — Make a formal property-specific projection of future capital expenditure needs, and make sure the property's projected revenue will be sufficient to fund those capital needs as they arise.
- **Construction and Lease-Up**
  - — Prepare the leasing staff to adjust rapidly to changes in the construction schedule.
  - — Establish a system for detecting changes in the neighborhood rental market and for modifying the marketing program in response to those changes.
  - — Establish good communications and an effective working relationship between the construction and property management staffs.
- **Normal Operations**
  - — Concentrate on the three essentials of property management: top quality site-level staff, sophisticated budgets, and professional management.
  - — Establish a capital expenditure plan that looks forward at least five years.
  - — Review the property's performance periodically; if performance is out of line with expectations, invest additional asset management effort to determine the causes of the problem, identify potential solutions, and implement a solution.
- **Intervention**
  - — If the property is not achieving its objectives take action early when the problems are more likely to be solvable.
  - — If the property requires financial restructuring, change of property management company, or other drastic action, establish and maintain good communication with all affected parties and take action early in the distress cycle.

As with participating jurisdictions, developers and owners will achieve the preceding objectives through a variety of methods. For experienced developers with top-flight affiliated property management companies, achieving operational excellence may be as simple as doing better capital expenditure planning in the pre-development stage and converting from one-year budgeting to five-year budgeting in normal operations. For developers who utilize third party property management companies, achieving operational excellence will probably require additional sophistication in monitoring operations plus development of an improved early warning

system. For developers in the early stages of establishing and expanding their organizations, achieving operational excellence will likely require very significant effort on a number of fronts; however, this additional effort is essential.

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