

# MILLENNIAL HOUSING COMMISSION

## PRODUCTION AND PRESERVATION TASK FORCES

### SUSTAINABLE UNDERWRITING PRINCIPLES

#### OVERVIEW

An affordable housing transaction has sustainable financing and structure if each of the following sustainability tests are met:

1. Long Term Capital Needs can be 100% supported from reserves, or from a combination of reserves and reasonably predictable refinancing.
2. Stabilized NOI is very likely to be achieved as projected.
3. DSCR is adequate to withstand moderately large adverse circumstances.
4. Financing is reasonable.
5. Trending assumptions are reasonable.

The determination that these tests have been satisfied requires real estate judgment based on good data and experience. Accordingly, the tests are described below in general terms and not in terms of specific percentages and ratios.

#### 1. LONG TERM CAPITAL NEEDS CAN BE 100% FINANCED

**Capital Needs Assessment.** There is a property-specific long term capital needs assessment that estimates the annual capital expenditures necessary to maintain the major building systems over the long term. The original capital needs assessment, prepared at the time of original structuring and approval, must be for a period of time long enough to encompass at least the first replacement of the major building systems (roof, siding, windows, parking lot resurfacing, HVAC, ...).

**Reserves.** The combination of any up front reserve funds, the initial monthly reserve deposits, and planned future deposits (increased at the rate of inflation, or perhaps more rapidly than inflation) is sufficient to fund at least a significant portion of the long term capital needs.

**Refinancing.** Any of the long term capital needs that cannot be funded from the reserve can be funded from future refinancing that is reasonably predictable, taking into account any affordability restrictions in the long term use agreement, and taking into account uncertainty about future property value and future mortgage market conditions.

#### 2. STABILIZED NOI IS REASONABLE AND ACHIEVABLE

**Rents.** Projected rents are very likely to be achieved, taking into account location, design, other property characteristics, and the long term use agreement. In particular, because occupancy is restricted by income level, the achievable rents for an affordable property are below the market comparable level that a non-income-restricted property could achieve.

**Vacancy / Rent Loss.** The rent loss allowance is reasonable considering the range of vacancy

and bad debt loss the property is likely to incur over a typical real estate cycle.

**Operating Expenses.** The property is very likely to meet or beat its projected operating expense budget. The projected operating expenses are based on actual operating costs of typical comparable properties that are at least five years old.

**Reserve for Replacement.** The projected reserve deposit is consistent with principle #1 above.

### **3. DEBT SERVICE COVERAGE IS ADEQUATE**

**Rent Variance.** If the rents that are actually achieved are modestly lower than the projected rents, the property will still be able to cover its required mortgage payments. If the actual rents are, say, 3% below projected levels, that should not throw the property into negative cash flow.

**Expense Variance.** Various components of operating expenses are subject to large variances. Examples include utility costs, real estate taxes, property insurance, and security costs. If the actual operating expenses are, say, 10% higher than projected, that should not throw the property into negative cash flow.

### **4. FINANCING IS REASONABLE**

**Original Financing.** The projected financing is either firmly committed or very likely to be obtained.

**Non Traditional Financing.** If the first mortgage is not fixed-rate, or is not self-amortizing, there is additional debt service coverage (or other financial protection) sufficient to give a very high degree of assurance that the property will be able to pay debt service over the long term.

**Subordinate Financing.** If the property includes “soft” junior financing, the terms of that financing are consistent with the property’s long term sustainability. For example, the subordinate lender should not have a right to repayment until expenses are paid, the property is maintained, and the reserves are adequately funded.

### **5. TRENDING IS REASONABLE**

**Revenue Trending.** The rate at which income is projected to grow in the future is consistent with restrictions in the long term use agreement and is less than the rate at which expenses are projected to grow in the future.

**Operating Expense Trending.** The rate at which expenses are projected to grow is consistent with reasonable long term projections of inflation.