CAPITAL AVAILABILITY REPORT

Housing Authority Insurance Group
Council of Large Public Housing Authorities
Public Housing Authority Directors Association
National Association of Housing and Redevelopment Officials

Contents

1. Executive Summary

In furtherance of the discussion regarding the feasibility of converting the nation's public housing stock to project-based rental assistance or project-based vouchers ("Project-Based Assistance") from the current Annual Contributions Contract ("ACC") program, the Council of Large Public Housing Authorities, the Public Housing Authorities Directors Association, the National Association of Housing and Redevelopment Officials, and the Housing Authority Insurance Group (collectively, the "Client") requested that Recap Real Estate Advisors ("Recap" or "we") investigate the availability of private capital for properties participating in this conversion (the "Converted Property(ies)", or the "Property(ies)"). As a result, we conducted interviews with lenders, Low-Income Housing Tax Credit ("LIHTC") equity investors and allocators, and affordable housing experts and developers (the "Interviewee(s)") to determine the likelihood, in their opinions, of Converted Properties receiving capital investment. Additionally, if the Interviewee was a capital provider, we sought to determine their level of interest in actually providing capital and to learn the terms they would seek for investment.

In order to give the Interviewees a sense of the underlying characteristics of a Converted Property, we formulated a hypothetical case-study transaction summary (the "Conversion Summary") using data gleaned from the analyzed dataset in Task 1, the Broad Data Analysis. The Conversion Summary describes a typical public housing authority ("PHA(s)") who would act as the sponsor/developer, a typical public housing property eligible for conversion, and the deal structure as envisioned under the current Rental Assistance Demonstration Notice (the "RAD Notice"). The goal of the Conversion Summary was to get the Interviewees comfortable with this idea by demonstrating that Converted Properties are almost identical to privately owned properties with Project-Based Assistance, as without the ability to provide a capital infusion to cure capital backlog ("Capital Backlog"), public housing properties undergoing the conversion process will continue to fall victim to chronic underfunding that is woefully inadequate to maintain the physical plant.

<u>**Converted Properties Will Be Able to Obtain Debt and Equity Financing**</u>

Overall, we found that the capital markets will not be biased against Converted Properties, as Interviewees largely believe that they will be able to look to the debt and equity markets for investment. We drew expertise from a broad spectrum of sources and were provided with reasonable consistency and had very few outlier comments. We learned that the Interviewees view Converted Properties like older, assisted affordable housing and, consequently, capital providers will most likely treat them this way when underwriting a potential investment. As a result, we believe that Converted Properties will be able to obtain debt and LIHTC equity investment.

The majority of our interviews, which were purposely lead by the Interviewees so we could learn what they see as the biggest issue(s), focused around the financial capacity and experience of the PHAs to take on the

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developer/sponsor role. The remaining talking points largely provided confirmation that capital providers will treat Converted Properties no differently than privately owned properties with Project-Based Assistance.

One area of concern for the Interviewees was the right and process to foreclose on a Converted Property. As set forth in the current RAD Notice, the RAD Use Agreement, which is co-terminous with the Project-Based Assistance contract, is recorded prior to the lien of the first mortgage and structured to survive foreclosure. Typically, when a property is foreclosed on, all use restrictions are eliminated so the foreclosing party can operate the property as they see fit. Additionally, although to a lesser extent than sponsor/developer experience, the Interviewees had concerns surrounding the appropriations risk of Project-Based Assistance, particularly if it is subject to annual appropriations, as proposed in the current RAD Notice. Although most of the Interviewees we spoke with stated that they did not see this is a deal-breaker, they did mention that they have become more uneasy with appropriations risk in recent years as ACC and Project-Based Assistance programs have seen drops in funding, and with large federal budget cuts on the horizon, this is not expected to change in the foreseeable future.

Greater detail regarding this exercise may be found within the narrative that follows this Executive Summary. Questions regarding the information presented herein should be directed to Thomas Davis, Senior Vice President, at tdavis@recapadvisors.com or (617) 338-9484.

2. Debt

From a purely real estate perspective, we learned that lenders would not underwrite a transaction on a Converted Property within a public housing portfolio any differently than one owned by a private investor. Each loan program's underwriting guidelines for determining cash flow available for debt service would determine, in conjunction with loan to value and other programmatic constraints, the amount of hard (i.e. must pay) debt a Converted Property could support. While historical data and observed trends would likely drive the underwritten operating expenses, the rental revenue stream and affordability restrictions post-conversion would impact projected revenues. The resultant net operating income would then be used to determine cash flow available to service the debt and therefore, the potential level of debt that the Converted Property could support.

Capacity of PHAs is Important

The largest talking point during our interviews was the capability and financial capacity of PHAs to take on the developer/sponsor role. Although the idea of a PHA as sponsor/developer is new to some, we found that many capital providers are comfortable with the idea, and some have already provided capital to PHA sponsored/developed deals. Like with any transaction, the sponsor/developer will be evaluated as part of the mortgage underwriting, with lenders looking at the experience and financial wherewithal of the PHA to determine whether, and at what level, a loan is made. Most loans require a guarantor with a strong balance sheet (i.e. unrestricted cash) to provide guarantees against certain events; the lack of this type of guarantor often results in the lender reducing proceeds to provide more cash flow cushion versus debt service or

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reduced proceeds versus value should a property need to be sold in a foreclosure situation. This was seen as an issue by some, as many PHAs do not have unrestricted cash, and thus, they do not have the capacity to make guarantees. However, most Interviewees did not see this as a non-starter because, as is currently done, PHAs can partner with an experienced affordable housing owner/operator to increase the lender's overall comfort with respect to the sponsorship or hire a development consultant to assist as needed. Additionally, PHAs could capitalize reserves (e.g. lease-up, transition reserves, etc.) from available resources and/or investment proceeds to mitigate the risk of a funding shortfall.

> **"The most important thing is the quality of the PHA. If they do not have a track record and a strong balance sheet, they will not be able to obtain a loan without a [development] partner. PHAs with a track record should be able to secure debt easily."**
>
> ***-- Affordable housing finance advisor and expert***

FHA Key to Conversion

In general, Federal Housing Administration ("FHA") loan programs, such as 223(f) and 221(d)(4) (depending on the level of Capital Backlog), were seen as the "go-to" for deals of this nature. FHA loan programs typically have the highest loan to value and lowest debt service coverage restrictions when compared to Fannie Mae and Freddie Mac loans, which is especially important for Converted Properties as they will need the highest amount of leverage possible to cure their typically large Capital Backlog amounts. Additionally, FHA loan programs have historically been a more reliable source of debt for properties with Project-Based Assistance subject to annual appropriations, as is expected to be the case for Converted Properties. Interviewees largely saw private lenders and the commercial mortgage-backed securities markets ("CMBS") as long-shot sources of debt financing because they seldom lend on deals with annual appropriations risk, and when they do, the leverage is typically low, resulting in a low loan amount.

> **"If you have annual appropriations risk, the best source of debt financing is FHA. You could potentially contort private lenders to lend [on Converted Properties], but only at a high debt service coverage ratio. If PHAs want any kind of leverage, they will need a FHA loan."**
>
> ***-- Affordable housing finance advisor and expert***

No Additional Capital Reserves Necessary

As with any debt financing, lenders typically require debt service and replacement reserves to be capitalized beginning with the closing of the loan. Lenders usually require a six month debt service reserve and no more than $500 per unit, per year of replacement reserve deposits over the life of the loan. Interviewees did not foresee any requirement(s) for additional or higher than usual capitalized reserves due to the nature of the Converted Properties.

Foreclosure Rights Pose a Potential Risk

Foreclosure rights were a heavily discussed topic as Interviewees believe that foreclosing on a PHA will be difficult, which could deter lenders from providing capital for Converted Properties. Additionally, Interviewees believe that lenders will have some concern regarding the RAD Use Agreement that remains in place, in perpetuity, even after a foreclosure. One Interviewee suggested that this will cause lenders to pause and possibly adjust the terms of their loan (i.e. reduce leverage), but that lenders will ultimately get comfortable with this issue. Another Interviewee suggested that if the Project-Based Assistance is terminated upon foreclosure, that Converted Properties will be shunned by lenders as they will not want to take the risk of leasing the Property at achievable market rents with no rental subsidy.

Uncertainty of Appropriations

Lastly, appropriations risk, and in particular, annual appropriations risk, as it pertains to Converted Properties under the current RAD Notice, was a heavily discussed topic. ACC and Project-Based Assistance programs have seen decreases in funding in recent years due to federal budget cutbacks and, given the current economic and political climate, this is not expected to change in the foreseeable future. As a result, some of the Interviewees believe that private lenders and the CMBS markets will not lend to Converted Properties because of this risk, especially given that Converted Properties will be subject to annual appropriations, which are deemed to be more risky than properties with Project-Based Assistance not subject to annual appropriations. Despite this, most Interviewees believe that PHAs will be able to obtain debt financing, with FHA most likely being the "go-to" source, and Fannie Mae and Freddie Mac being potential sources, but not as likely as FHA.

> **"This will cause pause, but will be figured out by lenders. We have done deals on properties similar [to the Converted Properties]. Essentially we would be making a bet on HUD, which is a good bet."**
>
> ***-- National Fannie Mae, Freddie Mac, and FHA lender***

> **"It's not going to be a major impediment, but it will give lenders pause. However, lenders are hungry today, so they will most likely want in on the action."**
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> ***-- CRA-motivated national lender and LIHTC equity investor***

3. Equity

4% LIHTC Allocations More Achievable for PHAs

In order to fully gauge whether PHAs will be able to rely upon LIHTC equity investment as a capital source, we interviewed both LIHTC allocators and equity investors. First, we set out to determine the likelihood of a PHA receiving a LIHTC allocation. This scenario would be ideal for Converted Properties because they could then obtain a lower loan amount, reducing leverage and making lenders more comfortable with the deal. Generally, we found that LIHTC stakeholders believe 9% LIHTC will be difficult, but not impossible, to obtain but that this varies widely by state. All states are required to allocate a minimum of 10% of their LIHTC to non-profit sponsored deals, which the PHAs will be eligible to compete under. Additionally, many states have rehabilitation and/or preservation set-asides that the Converted Properties can apply under. Also, a typical theme in many states' Qualified Allocation Plans is the higher the dollar amount of rehabilitation per unit, the more likely a project is to receive an allocation, so, given that many of the Converted Properties have significant Capital Backlog, 9% LIHTC allocations may be feasible in some states. Conversely, most Interviewees believe that the likelihood of Converted Properties obtaining tax-exempt bonds, and thus, receiving an automatic 4% LIHTC allocation is high. Furthermore, if the PHAs can secure soft money in conjunction with a 4% allocation, the deal will look like it received a 9% LIHTC allocation because the PHA can use the proceeds from the sale of the LIHTC to pay down the principal on the tax-exempt bonds.

PHA Capacity Important to LIHTC Equity Investors

Similar to the conversation surrounding debt financing, from an underwriting perspective, Converted Properties would be viewed by LIHTC equity investors in the same light as if they were operated by a private affordable housing developer; however, the operational capabilities and financial wherewithal of the PHA to act as the sponsor/developer, like with debt financing, caused concern among the Interviewees. Again, Interviewees would require a guarantor with a strong balance sheet (i.e. unrestricted cash) to provide guarantees against certain events as financial strength enhances the level of comfort with a proposed investment. In addition to financial capacity, many Interviewees suggested that experience with LIHTC compliance and tenant relocation, if necessary, would be required of the PHA, and if no they had no experience, that the PHA would be required to hire a third party who was expert in these matters. That being said, Interviewees largely agreed that PHAs would almost always be viewed in a more positive light if some type of joint venture (whether co-general partners or otherwise) was formed with an experienced affordable housing developer, especially one with financial strength, or if a development consultant with extensive LIHTC experience was hired. Should a PHA want to act alone as a general partner and transaction sponsor, a successful development track record and sufficient levels of unrestricted cash available for guarantees would be a pre-requisite.

> **"As long as the capital improvements are significant, I do not think a [LIHTC equity] investor would view a Converted Property any differently than any other affordable housing deal."**
>
> ***-- Experienced national LIHTC syndicator***

Large Upfront Capital Repairs Expected

Another major topic of discussion surrounding LIHTC equity was the amount of capital repairs that would be performed in the initial rehabilitation at the Converted Properties, upon investment, as opposed to making repairs on an as-needed basis in the future. The general consensus among Interviewees was that all major replacement/renovation items (e.g. roofs, systems, in-unit upgrades) scheduled to be addressed in the first 15 years – a number equal to the LIHTC compliance period – as outlined in a required capital needs assessment, would need to be performed as part of the initial rehabilitation. The reasoning behind addressing the major items in the initial rehabilitation is two-fold. First, a higher amount of rehabilitation will result in a larger LIHTC allocation, which benefits the investor as they want the highest amount of LIHTC possible, in addition to keeping the Property competitive for the foreseeable future. Second, addressing 15 or more years of capital needs will eliminate tenant disruption in future years, which could cause an increased rate of tenant turnover when repairs in future years are needed. Furthermore, in addition to making LIHTC equity investors more comfortable investing in the deal, Converted Properties completing 15 years of capital needs in the initial rehabilitation will be more attractive to lenders, which could lead to more favorable financing terms. Also, it should be noted that the current RAD Notice states that early replacement of components due to increasing the upfront rehabilitation will reduce the required annual replacement reserve deposit amount, which will increase cash flow and make the deal more appealing to LIHTC equity investors and lenders.

Given the large amount of Capital Backlog that many of the Converted Properties have accumulated over the years, replacement/repair of major systems and building components will need to be performed as part of the initial rehabilitation at many Properties as a matter of course. As a result, LIHTC equity investors seeking 15 years of scheduled capital needs to be addressed upfront should not be viewed as problematic. Additionally, although all of the Interviewees suggested that they would seek to have all the major capital needs scheduled in the first 15 years addressed as part of the initial rehabilitation, we believe that not all LIHTC equity investors will hold to this standard, and thus, Converted Properties not having sufficient funds to meet this requirement will most likely still be able to obtain LIHTC equity investment.

> **"We look at LIHTC deals as one bite at the apple. We want 15 or more years of capital repairs taken care of upfront, not through reserves or grant programs, which starts to muddy the waters for investors."**
>
> ***-- Experienced national LIHTC syndicator***

<u>Section 8 Overhang a Concern</u>

As for appropriations risk, we learned that equity providers are typically more comfortable with it than lenders, especially in strong markets where achievable market rents are at or exceed the allowable LIHTC maximum rent. Although most Interviewees believe LIHTC investors are comfortable with appropriations risk, one area of concern is when Project-Based Assistance contract rents exceed allowable LIHTC rents ("Section 8 Overhang"), which can happen in any market and for a variety of reasons, but is most worrisome in weak rental markets where achievable market rents are below maximum allowable LIHTC rents, thus increasing the Section 8 Overhang amount. This is seen as an issue, particularly given the economic and political climate as previously discussed, because if the Project-Based Assistance were to be terminated on a Converted Property where Section 8 Overhang exists, rents would then drop to the achievable market amount, which may or may not be the maximum allowable LIHTC rent, and could cause the Property to begin to operate at a loss and increase the risk of default.

One potential alleviant for LIHTC equity investors on Converted Properties is the fact that Project-Based Assistance contract rents will be based on current funding levels instead of comparable market rents, which would generally be higher, and will result in less Section 8 Overhang than on a typical property with Project-Based Assistance, as the gap between the Project-Based Assistance contract rent and maximum LIHTC rent will be smaller. Another potential mitigant is the location of a Converted Property. Converted Properties located in strong rental markets will often have achievable market rents at or above the maximum allowable LIHTC rents. Conversely, Converted Properties located in weak rental markets will often have achievable market rents below maximum allowable LIHTC rents. As a result, the gap in Section 8 Overhang will often be lower for Converted Properties located in strong rental markets because if the Project-Based Assistance were to be terminated, the achievable market rents would be reduced by a smaller amount. That being said, Converted Properties located in strong rental markets will make investors more comfortable when contemplating investment.

To further alleviate the Section 8 Overhang concerns of LIHTC equity investors, some Interviewees suggested that PHAs capitalize a transition reserve to mitigate the risk of termination of the Project-Based Assistance, which can be large and restrict much of a Converted Property's cash flow, if any. Although this is not ideal for the PHAs given that they typically do not have adequate resources to fund such a reserve, it does provide an additional avenue to entice LIHTC equity investment. Additionally, it should be noted that Section 8 Overhang may cause lenders to reduce the leverage of their loan, which could create a funding gap. However, despite all of these concerns, Section 8 Overhang is an issue that is structured around in current investments, so obtaining LIHTC equity investment on a Converted Property will most likely be feasible.

> **"Finding a LIHTC equity investment will not be an issue if the project can obtain debt financing."**
>
> ***-- Affordable housing finance advisor and expert***

4. Conclusion

As demonstrated above, based upon the interviews conducted, we have concluded that capital providers will largely view Converted Properties like older, assisted affordable housing, and, as a result, will seek to provide capital if presented the opportunity. We drew expertise from a broad spectrum of sources and were provided with reasonable consistency and had very few outlier comments, which is promising as PHAs begin to explore the capital markets to cure Capital Backlog that has largely been long overlooked.

In general, our discussions show that debt financing, will largely be available to Converted Properties via FHA, Fannie Mae and Freddie Mac loan programs. Although Interviewees do see obstacles to obtaining debt, the general consensus was that lenders will look past these issues and widely accept the Properties as typical assisted affordable housing, which they current lend on today.

As for LIHTC equity investment, Converted Properties should not have any trouble finding investors – especially in primary and some secondary markets as the Community Reinvestment Act requires commercial banks and savings associations to invest in the communities in which they operate, which includes providing LIHTC equity – if the PHA has LIHTC experience and financial capacity, or partners with a third party to fulfill these criteria if the void exists. We tend to believe that if a PHA is able to secure debt financing on a converted property, that if a LIHTC allocation is awarded to the property, sourcing LIHTC equity should be a relatively easy exercise.

> **"We are extremely interested in participating in this process with PHAs…and really want to play in this market."**
>
> -- ***CRA-motivated national lender and LIHTC equity investor***

5. Exhibits

A. Definitions of Terms Used

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Exhibit A
Definitions of Terms Used

1.	ACC	Annual Contributions Contract
2.	Capital Backlog	Capital repairs that are needed immediately.
3.	Client	The Council of Large Public Housing Authorities, the Public Housing Authorities Directors Association, the National Association of Housing and Redevelopment Officials, and the Housing Authority Insurance Group.
4.	CMBS	Commercial mortgage-backed securities
5.	Conversion Summary	The case study sent by Recap to the Interviewees.
6.	Converted Property(ies) or Property(ies)	Property(ies) that convert from ACC to Project-Based Assistance.
7.	FHA	The Federal Housing Administration
8.	HAP Contract	The Section 8 Housing Assistance Payments Contract funded by HUD.
9.	HFAs	Housing finance agencies
10.	HUD	The Department of Housing and Urban Development

11. Interviewee(s)	The lenders, LIHTC equity investors and allocators, and affordable housing experts and developers interviewed by Recap and cited in this Report.
12. LIHTC	Low-Income Housing Tax Credits
13. PHA(s)	Public housing authority(ies)
14. Project-Based Assistance	Project-based rental assistance or project-based vouchers
15. RAD Notice	The Rental Assistance Demonstration Notice
16. RAD Use Agreement	The Rental Assistance Demonstration Use Agreement described in the RAD Notice.
17. Recap or we	Recap Real Estate Advisors
18. Section 8 Overhang	Project-Based Assistance rents in excess of maximum allowable LIHTC rents.

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