

## Financial Analysis of a Credit Deal

By

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Reprinted from *Developer's Guide to the Low Income Housing Tax Credit* (4<sup>th</sup> ed. 2000)

Developers, investors, and lenders must all work with projections in analyzing the financial feasibility of Housing Credit properties. For developers it is essential to "build" the project on paper before ever building it in real life. In the same way that a set of architectural drawings and construction plans describe the physical characteristics of a project, a set of financial projections describes how much a project costs to build, and whether it can be operated each year so that the income meets all the expenses. In addition, a set of projections should describe the tax benefits being allocated to the investor and the sharing of fees and cash distributions from the project.

Attached is a simple set of projections for a newly constructed apartment complex. These projections are part of a more complete set prepared by the accounting firm of Reznick Fedder & Silverman, C.P.A.s, for this apartment complex. The complex is comprised of 50 garden style apartments comprised of 36 one-bedroom and 14 two-bedroom units. The developer obtained a Housing Credit allocation from the State Credit Agency in 1999, and started construction that year, intending to finish construction in 2000. The developer intended that 100 percent of the units would qualify for Housing Credits.

### **Step 1: Calculating Development Costs**

The first page of the projections is shown as Chart 1. This chart includes basic information on the development and assumptions such as the Housing Credit percentage as of the month of allocation. The second part of this chart itemizes the total construction and development costs for the project. This should include all costs necessary to purchase the land and complete the construction of the apartment complex. It also contains amounts for developers fee, contractors profit and other fees. Some of these fees are not includable in depreciable or eligible basis, but they are typically included as an element of overall construction cost to demonstrate there is enough money from all sources to pay these fees.

### **Step 2: Calculating the Developer Fee**

Chart 1 also demonstrates the calculation of developer fee and contractor profit. The amount of the developer fee and the contractor profit is typically limited by State Credit Agency rules. According to the rules in this state, the total of the developer fee, contractor profit, and general overhead cannot exceed 15 percent of all other depreciable costs plus land. In this case, they equal 11.4% in total. The amounts determined for the

various fees, profit and overhead are then used in the chart to calculate the total development cost.

### **Step 3: Balancing the Sources and Uses**

Chart 2 shows the basic sources and financing and how this financing is used during development. This is the “sources and uses” that is often referred to as a requirement for investors. Chart 2 also shows how the various expenses are treated for federal income tax purposes, which is necessary to consider in calculating the amount of credits and losses which a project will generate. Chart 3 shows the details about the different sources of debt. The uses part of chart 2 is familiar, because it is a copy of the list of construction costs contained in Chart 1.

Finally, Chart 2 shows that only \$3,244,170 of the total development cost of \$3,691,340 is capitalized. This means that, for federal income tax purposes, only \$3,244,170 can be depreciated over the depreciable life of the building, or 27.5 years. In addition, this is the amount which the Housing Credit rules require to be used in order to determine eligible basis and, later, qualified basis. Other expenses shown in Chart 2 are listed as either “funded expenses” or “nonamortized.” The funded expenses will be subject either to current deduction or to some other form of ratable deduction over a period of years, called amortization. The final column shows costs (the primary one being land) which cannot be depreciated or amortized but must instead be kept as basis for use in determining the ultimate gain on sale of the property.

### **Step 4: Will There Be Enough Money To Build the Project?**

As mentioned above, it is essential during the development and operation of a project that sources and uses balance. In other words, there must always be enough money during the construction period to finish constructing the property. Chart 4 shows the schedule of capital contributions during the construction and the initial operation period. The construction of the project started in August, 1999 and was to be finished in August 2000. For this financing structure, the timing of the investor capital contributions was crucial. The investor was unwilling to put any capital into the project until the project was completed. Notwithstanding this severe constraint, the developer was able to make the project feasible. The developer obtained a construction loan in the amount of about \$1.3 million, other loans and grants in the amount of about \$850,000, and an interim development loan (bridge loan) in the amount of about \$1.3 million. These paid all costs except part of the developer fee. The construction loan was paid off by the investor’s first equity payment of \$1.3 million. The investor’s second contribution of \$70,664 paid off the developer fee. The rest of the investor’s capital contributions were used to pay off the bridge loan. (See Chart 5 for this loan amortization).

This financing structure is somewhat unusual in that a large portion of the investor’s equity is contributed during operations, long after completion, rent up, and breakeven. (This “back loaded” schedule for equity increases the investor’s yield while still allowing payment of 83 ¢ per credit dollar – a high amount at the time based on the market for

credits.) The structure is typical, however, in showing how creative financial planning is needed to develop low income housing. In this case, the ability to obtain a 5 year, 2% bridge loan meant that the developer could "back load" the timing of the equity, and get more equity as a result.

#### **Step 5: Calculating the Housing Credit Amount**

Chart 6 shows how the maximum Housing Credit is calculated based upon the depreciable basis shown in Chart 2 of \$3,244,170. After subtracting the federal grant of \$55,000, the eligible basis is \$3,189,170. Because this is a 100 percent low income project, this eligible basis equals the qualified basis. Since the project is located in a difficult development area or a qualified census tract, it is eligible for the 130 percent adjustment. Thus, the basis for calculating the credit is \$4,145,921. In the month of allocation, the Housing Credit percentage was 8.32 percent. This percentage rate multiplied by the qualified basis will equal the total projected Housing Credit for the property of \$344,941, but since only \$340,236 was allocated by the state agency, this lower amount must be used. In order to determine the amount of this Credit available to investors, the investor's percentage, in this case 99.99 percent, must be applied to this number to determine the amount of annual Housing Credits available for the investor of \$340,202.

Although it is not shown on a chart, the amount of annual Housing Credits available to the investor is what determines the amount of equity, or capital contribution, included in the sources and uses schedule in Chart 2. The capital contribution is calculated as follows: The annual credit to the investor (\$340,202) multiplied by 10 years will equal \$3,402,020. In 1999, the investor was willing to pay 83 ¢ per dollar of Housing Credits for this project. Multiplying \$3,402,020 times .83 equals about \$2,936,090. This is the number used for the investor's capital contribution on Chart 2.

#### **Step 6: Calculating the First Year Credit**

Chart 7 shows how Housing Credits for the first year of the Credit period are determined based on actual occupancy during the year. As shown in Chart 7, it is not until December, 2000 that all 50 units are occupied by qualifying tenants. Therefore, the maximum Housing Credit amount for the months July through December is prorated based on the number of the 50 units actually occupied by low income households. The result is that the total first year Housing Credit is \$112,226, rather than the full year of \$340,236. The difference between these two numbers will be allowed to the project in the 11<sup>th</sup> year. This is an extremely important calculation for the developer and the investor.

The difference between receiving credits in the first year and the 11<sup>th</sup> year is significant to an investor, because the investor calculates its profit or return on equity based on both the amount of return, and when this return is received. In other words, a dollar of Housing Credits received in the first year is worth a dollar; a dollar of Housing Credits received in the 11<sup>th</sup> year is worth between 20 cents and 40 cents. Therefore, the amount of Housing

Credit actually delivered in the first year is critical to the price per Housing Credit which an investor is willing to pay.

#### **Step 7: Calculating Rental Income and Net Cash Flow**

Chart 7 shows the rental income schedule by unit size. This schedule specifies the gross monthly rent, the utility allowance, and the resulting net monthly rent. These calculations should be based on a thorough market study. In addition, the developer must ensure that the figures used for utility allowance and net monthly rent are within the Housing Credit limits set by Section 42. This rent level is determined on the basis of the family size which is deemed to live in the specific size apartments.

The second part of Chart 7 shows how the rental income is calculated for the first year of the project's operation, based on the rent-up schedule discussed above.

Chart 7 also shows the annual operating expenses which are expected for the first full year of the project's operation. This chart also contains the important assumptions regarding the trending of income and expenses for future years. No one knows how expenses and income will rise, in general, and, in particular, how they will rise for this project. This example uses an annual increase in rental income of three percent per year (shown as 103%), and an annual increase in expenses of four percent per year (shown as 104%). The assumed increases in income and expenses are viewed today as conservative (or, perhaps, realistic). In any event, most investors are comfortable using these trending assumptions for future income and expenses. This, however, may change based on their experience with this type of real estate.

Chart 8 shows how the rental income will increase each year, based on the above assumptions, and how the vacancy assumption and operating expenses reduce the gross rental income to "net operating income," which is used to pay debt service on the first mortgage loan.

#### **Step 8: Calculating the First Mortgage Amount**

To calculate the maximum permanent first mortgage loan amount, a developer must know the basic interest rate on the loan, the amortization period (the number of years over which the loan is calculated to amortize, usually 25 or 30), and the loan term. Lenders typically allow a 25- or 30-year amortization period for purposes of calculating the monthly payment, but require that the entire loan balance be payable in 15 years. Obviously, if a lender uses a 25-year amortization period and a 15 year loan term, there will be an outstanding principal balance to pay off at the end of 15 years. In the process of obtaining a loan, however, a shorter loan term may be a trade off for the developer in order to obtain a slightly lower interest rate.

Developers must also understand the concept of debt service coverage ratio, a ratio of the monthly net cash flow for a project to its monthly loan payment. Most commercial lenders today require at least a 1.15 to 1.25 debt service coverage ratio, while many

government agencies may require only 1.10 debt service coverage ratio. These ratios assure the lender a certain amount of cash flow is available over the amount needed to pay the monthly loan payment. For example, a lender with a 1.15 debt service coverage ratio requirement would require for every \$1,000 of loan payment each month, there be at least \$1,150 of net cash flow each month.

The lenders' maximum mortgage amounts are then used in the original sources and uses schedule (Chart 2) described above. After applying this figure and adding it to the investor's capital contributions, any remaining project expenses must be paid out of the project's cash flow. As in this case, the developer can sometimes obtain a "soft" loan from a state or local government source, such as HOME, CDBG, or other state housing program funds. These monies are often used to fill the "gap" which exists between the sources and uses of funds.

### **Step 9: Calculating the Investor's Benefits**

Chart 9 summarizes the expected operation of the project on a tax basis (rather than a cash basis) over the 15-year compliance period and the expected tax consequences. This chart shows the project's net operating income and deductions for depreciation, mortgage interests, and fees. The chart also shows the resulting taxable income or loss each year. For the first 15 years of the compliance period, the project is expected to experience a loss for tax purposes. The chart also shows the amount of this loss allocated to the investors and the amount of Housing Credits allocated to the investors.

Chart 10 summarizes the investor's total capital contributions, net tax losses, tax benefits, cash flow, and Housing Credits. The tax benefits are calculated by applying the maximum corporate income tax rate (approximately 35 percent) to the tax losses each year. This represents the benefit to a corporate investor of these losses on its tax return.

Chart 11 shows the final benefit, or cost, to the investor based upon a sale of the project at the end of 15 years for a price equal to the outstanding balance on the mortgage loan at that time. In this case, the investor still has a positive capital account (because the losses previously taken are less than its capital contributions) so there is a loss realized for tax purposes upon such sale. The loss of \$1,363,589 is deductible to the investor so it produces a tax benefit of \$477,256 in the year of sale. If the investor had a negative capital account, it would have a "gain" for tax purposes (even though there was no cash from the sale) and would owe taxes on this "phantom gain." These taxes, known as exit taxes, must be taken into account by an investor when it is analyzing its expected return from a Housing Credit project.

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## Exceptions to the Rule: Understanding the Significance of Re-Benchmarking HUD's Income Limit Data

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The U.S. Department of Housing and Urban Development (HUD) estimated U.S. median family income rose from \$54,400 in 2002 to \$56,500 for 2003, a 3.9 percent increase. However, HUD reported substantial number of increases and decreases in the figures presented in the fiscal year (FY) 2003 Median Family Income Estimates because the estimates were "re-benchmarked" with 2000 Census data.

HUD's income limits, which were released February 21, are available for all Metropolitan Statistical Areas (MSAs), Primary Metropolitan Statistical Areas (PMSAs), and non-metropolitan counties. Median family incomes are assessed from half the families earning incomes above the median level and half earning incomes below the median level. HUD's income estimates are calculated for metropolitan areas and non-metropolitan counties in the United States and its territories using the fair market rent (FMR) area definitions used in the Section 8 program. While income limits are generally based on HUD estimates of median family income, it is important to note that this is not always the case. The statute refers to 50 percent and 80 percent of area median family income, but then provides modifications so that the terms often have no relationship to arithmetic values.

### Exceptions Preventing Income Decreases

The very low-income limits (generally 50 percent of area median income) are used to compute maximum rents and maximum income limits for low-income housing tax credit (LIHTC) units in accordance with IRS Revenue Ruling 89-24 (See February 2003 *Property Compliance Report*). In 2003, as a result of a process HUD describes as "re-benchmarking," various areas in 13 states and the District of Columbia experienced decreases in median family income, but in some cases HUD froze at last year's levels the very-low income limits that otherwise would have decreased due to decreases in median family income; this is referred to by HUD as the "historical exception." Some of these areas avoid any decrease in income limits based on HUD's high housing cost methodology or its state median methodology. As a result of

these HUD methodologies, there were no decreases in the very low-income limits published by HUD between 2002 and 2003.

The three categories implemented by HUD that prevented income limits from decreasing can be summarized as follows:

- **Historical Exception:** Income limits were maintained at last year's level because they would have decreased as a result of census re-benchmarking. To minimize program management problems, income limits are not allowed to fall below previous year levels in areas where census re-benchmarking or FMR reductions would have resulted in lower income limits.
- **High Housing Cost:** Income limits were based on FMRs. HUD's high housing cost exception is due to the fact that 85 percent of FMR divided by 35 percent is greater than statistical income. For example, the four-person income limit is calculated as the amount of income required to afford a two-bedroom unit renting at 85 percent of the FMR if 35 percent of income is used for rent (this adjusts income limits upward for areas where rental housing costs are unusually high in relation to the median income).
- **State Median Based:** In no instance are income limits less than if based on the state non-metropolitan area median income.

Joseph P. Riley, director of HUD's economic market analysis division (EMAD), says the historical exception was employed in areas where income estimates decreased but HUD has frozen the income limits at last year's level. The historical exception is a temporary measure meant to avoid disturbance in certain programs, and Riley says he expects that in most areas the exception will last only a few years. He

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## Exceptions to the Rule

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says it is generally HUD's policy that income limits do not go down.

"There are contracts and programs that are tied to income levels that might not be economically viable with lower income limits," Riley says. "They're based on the assumption that income limits don't go down."

He also says the number of changes made to this year's limits is high because of the incorporation of the 2000 Census data, but that it was otherwise not surprising. "There was more variation from our estimates than I would have expected, but it was not unusual compared to the last census re-benchmarking," Riley admits.

### Estimating Future Income Increases

Because statistical income levels and FMRs may be significantly less in certain areas, it may be several years before they see increases. Future increases to income limits in areas affected by the three categories below can be summarized as follows:

- ♦ **Historical Exception:** Future increases depend on either the FMRs or area median income increasing; and any increases may take several years depending on the area. Areas with high FMRs are most likely to be affected by increases in FMRs, as opposed to statistical income limits, especially if FMRs are very close to breaking through the 2003 income limits. Statistical income limits may be further behind.
- ♦ **High Housing Cost:** Future increases are likely to be affected by FMR levels.
- ♦ **State Median Based:** Future increases are likely to be affected by state non-metropolitan area median income.

Attachment 4 from the "FY 2003 HUD Income Limits Briefing Material" has been modified and included here to show the variance between HUD's published very low income and the 50 percent median income and high housing cost income. This variance can be used to estimate, for those areas with historical exception income, how far below the 50 percent median income or the high housing cost income is from the 2003 historical exception income, and thereby estimate how many years it may be until the income changes in those areas. Column <G> was taken from HUD's "Fair Market Rents for the Housing Choice Voucher Program....Fiscal Year 2003." Column <E> is calculated using the HUD's high housing cost methodology; calculated as the amount of income required to afford a two-bedroom unit renting at 85 percent of the FMR if 35 percent of income is used for rent.

### Examples

New York and Miami are listed as historical exception areas, which means that the income limits were maintained at last year's level since they would have decreased due to census re-benchmarking. Future increases are most likely

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to be affected by increases in FMRs as opposed to statistical income limits since FMRs are very close to breaking through the 2003 income limits, while the statistical income limits are further behind.

New York Published Very Low-Income \$31,400  
New York High Housing Income \$30,050  
New York 50 Percent Median Income \$25,950

Miami Published Very Low-Income \$24,100 Miami High Housing  
Income \$23,700  
Miami 50 Percent Median Income \$21,900

Los Angeles and San Francisco are listed as high housing cost areas, which means that the income levels were based on FMRs. Therefore any future increases are likely to be affected by FMR levels.

Los Angeles High Housing Income \$28,200  
Los Angeles 50 Percent Median Income \$25,150

San Francisco High Housing Income \$56,550  
San Francisco 50 Percent Median Income \$45,750

San Jose is not listed on Attachment 4 because 1) statistical income levels did not decrease as a result of the census, 2) FMR income level determinations are not greater than the area median income, and 3) the area median income is more than the state non-metropolitan area median income

San Jose Published Very Low-Income \$52,750  
San Jose FMR Very Low-Income \$51,300  
San Jose Statistical Very Low-Income \$52,750

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