

# HOUSING BOND REPORT

A MONTHLY PUBLICATION ON THE LOW-INCOME HOUSING TAX-EXEMPT BOND INDUSTRY

November 2003, Volume VI, Issue XI, Published By Novogradac & Company LLP

## Acquisition/Rehabilitation Financing; a Critical Business Segment of the Multifamily Industry

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Although the development community is enjoying historically low interest rates, there are some scarce resources in the current environment that are coming to bear on multifamily development. Topping the list is the high cost of developable land, exacerbated by the lengthy and costly time it takes to rezone and entitle land parcels for multifamily development.

No wonder developers, in addition to new project construction, have increasingly turned their attention to acquisition/rehabilitation transactions as their activity of choice. Essentially, the strategy is an "asset repositioning," i.e. making an older project competitive with newer comparable properties within its position in the sub-market. The challenge is to find sufficient debt dollars for both acquiring and renovating the units. Most older market-rate projects require only moderate renovation of the units (kitchen and bath remodeling) plus the construction of project amenities (such as swimming pool, ball courts, tot lots, gazebo and outdoor barbeque or the addition of a clubhouse facility), to be made competitive with newer project offerings.

For both market rate and affordable projects, one strategy is to purchase the property with an interim loan or so-called "bridge" facility. Because the majority of traditional lenders hedge advance rates against historical net operating income (NOI), (with no credit for the enhanced income stream from property renovation), 65 percent to 70 percent loan-to-value ratios (LTVs) "as-is" are often the best that can be achieved without more expensive mezzanine debt that bears the "double underwriting" cost of an interim (or construction) lender. The last alternative is to place a seller carry back second trust. However, most sellers in an active market are unwilling to do this.

The solution to this dilemma is the underutilized FHA insured 223(f) mortgage for acquisition and moderate rehabilitation, or the 221(d) program for substantial rehabilitation. The unique feature of the FHA insured underwriting is that HUD will insure the property mortgage up to:

- ♦ 85 percent LTV for a moderate rehab, 223(f);, (with a DCR of 1.17x) based upon the appraiser's opinion of the rent income stream, *as rehabilitated and restabilized*
- ♦ 90 percent of project cost or 1.10 DCR for a substantial rehab, 221(d);, *as rehabilitated and stabilized*.

This giving credit to enhanced rent income stream is a departure from almost all other industry underwriting because FHA has a more liberal underwriting standard for generating and preserving rental housing stock. In other words, the FHA approved appraiser and the Multifamily Accelerated Processing (MAP)-approved designee underwrite to the *post rehabilitation stabilized NOI*.

The MAP program (similar to the "delegated underwriter" process for Fannie Mae DUS) may be used for all multifamily products, from market rate to deeply affordable, including "mixed-use" projects with a portion of commercial space.

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# Acquisition/Rehabilitation

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In cases of a "rolling" rehabilitation, the lender may set up an operating deficit reserve for tenant displacement and any temporary vacancy. The rehabilitation budget portion of the mortgage facility will customarily be disbursed as several quarterly draws, based on the percentage of completion and lender inspections. Rather than requiring a separate construction lender, (or letter of credit provider to a forward commitment), both the FHA 223 (f) and 221 (d) give the developer/sponsor, through simple draw advances up to the full approved mortgage amount, the capability of eliminating expensive construction transaction costs.

The FHA 223(f) provides a fully amortized, 35-year mortgage from a single source and the FHA 221 (d) for a 40-year term, both of which are assumable to subsequent credit-worthy owners. Current Ginnie Mae long-term lending rates are available at 47-year, historically low interest rates.

In summary, the FHA 223(f) and FHA 221 (d) insured transactions are a highly useful financing technique for acquisition and property rehabilitation without duplicative construction period transaction costs. They are available for use on all multifamily projects, from market rate to deeply affordable preservation projects. The cost savings and single finance source for a fully funded long-term multifamily mortgage rehabilitation/permanent instrument demonstrates the underutilization of this highly desirable financing technique in the market today. Many developers are simply not aware of the high leverage, non-recourse nature of these under-appreciated executions. ❖

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*This article first appeared in the November 2003 issue of Novogradac & Company's Housing Bond Report and is reproduced here with the permission of Novogradac & Company LLP.*

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