EXCERPT

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Considerations for PHAs Thinking about Partnering with Developer on RAD Transaction

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Editor's note: This includes an excerpt from the 2023 Novogradac Rental Assistance Demonstration Handbook, scheduled to be published this month. Rich Larsen is the author of the handbook.

One of the biggest decisions for a public housing authority considering a transition of its property through the Rental Assistance Demonstration (RAD) program is whether to partner with a private developer.

RAD, which was enacted by Congress in 2012 to preserve and improve public housing properties, is administered by the U.S. Department of Housing and Urban Development (HUD). Through RAD, PHAs can convert HUD Section 9 funding and HUD's other nonpublic housing legacy rental assistance programs to HUD Section 8 funding with private ownership for public housing. HUD reported in October that investment in RAD properties has surpassed $15 billion and that more than 185,000 homes have been built, rehabilitated or preserved through RAD.

For many PHAs, the possibility of the transforming of its inventory is a daunting challenge that brings at least a discussion of partnering with a private developer.

This isn't just about the ability to complete the development, although that's a significant factor. The decision also weighs financing, because when a PHA seeks financing for a RAD conversion, investors look for significant experience. Investors evaluate the development team, with a consideration of whether the PHA is capable of handling the construction and compliance with the low-income housing tax credit (LIHTC) process–since LIHTCs help fund a significant percentage of RAD developments. The fact that the penalty for falling out of LIHTC compliance is the loss of credits (compared to a generally less harsh penalty for falling out of compliance with HUD regulations) means that outside parties will need to be confident that the right team is in place.

It is crucial for a PHA to have the ability to negotiate fair and reasonable business terms relative to:

- ownership and control provisions;
- development, property management, resident services and asset-management decisions
- making decisions and/or extent of participation;
- predevelopment funding and guarantee provisions;
- fee/cash flow splitting;
- back-end right-to-purchase;
- developer/partner's experience in working in PHA's jurisdiction and ability to secure LIHTCs, gap financing; and
- developer/partner's ability to work with residents, particularly in regard to relocation in a supportive manner.

Regardless of whether a PHA decides to be the developer of the RAD transformation or to work with a private developer, compliance with the regulations guiding the financing structure before, during and after the RAD transaction is important. One way to handle compliance is to have a contract with a third party.

Argument for PHA as Developer

However, there are arguments for the PHA to serve as the developer, presuming it has the experience and expertise to do so.

The first reason is financial: PHAs can earn a developer fee if they work with tax credits and oversee their own development. PHAs need experience to handle this, so some PHAs have elected to partner with a private developer on the first set of buildings (for instance, on the RAD renovation of a portion of the PHA's portfolio, serving as a co-developer). This allows the PHA to get a part of the developer fee and to learn how to handle a RAD conversion so it can serve as the developer for the remainder of the PHA portfolio and retain the developer fee. In this scenario, the PHA will then hire a construction manager, contractor, architect and other positions, duties normally handled by a private developer.

Significant for the PHA is to be able to demonstrate to potential investors that the PHA can handle the developer role. Successfully being able to handle the role of developer means the PHA can keep the developer fee, which can reach 15% of total development cost in a LIHTC property.

PHA Guarantees

There is another important financial concern that must be addressed by a PHA that operates as the developer or general partner while using LIHTC equity. In this scenario, the PHA will be expected to make certain guarantees to the investor limited partner, such as:

- tax credit guarantees, where the PHA agrees to refund to the investor any loss or reduction of tax credits due to project noncompliance or lease-up delays;
- operating deficit guarantees, where the PHA agrees to fund any operating losses until the development hits certain projected financial milestones;
- construction guarantees, where the PHA agrees to fund any costs of construction for
- the development in excess of budgeted amounts; and
- repurchase obligation, where the PHA agrees to buy back the investor's interest in the partnership if the development misses major deadlines that could jeopardize the completion of the project. The purchase price usually approximates the equity contributed by the investor.

The issue for PHAs and investors is that if the PHA is required to make good on such guarantees, it cannot use federal funds to do so–a difficult chore, since a significant portion of PHA funds may be considered "federal funds," and are thus restricted for a specified purpose by regulation. PHAs can only make good on guarantees with "nonfederal" or "unrestricted" funds.

Since many investors don't normally work with PHAs on tax-credit transactions, they could miss this nuance and settle for "guarantees" that are not full guarantees. For PHAs, this scenario requires a financial analysis at the fund level, identifying which funds are subject to federal regulation and/or state or local regulation and are therefore not available for general use. This helps identify which funds can be used to pay off a guarantee.

Following is a partial list of typical PHA programs, identifying which are considered "federal" (and not available to pay on a PHA guarantee) and "nonfederal" (available to pay on a guarantee):

Federal programs/funds

- low-rent public housing program reserves;
- post-2003 housing choice voucher program administrative fee reserves;
- unused federal grant funds such as Community Development Block Grants, Resident Opportunity

and Self-Sufficiency grants and capital fund grants; and

- HUD multifamily loan programs.

Non-federal programs/funds

- developer fees and management fees earned by the PHA;
- business activity funds;
- central office cost center reserves;
- pre-2004 housing choice voucher (HCV) program administrative fee reserves;
- certain affiliate and component unit entities; and
- certain Section 8 program reserves.

This represents a general list. The PHA should consult with its HUD asset manager for any exceptions or modifications to certain agreements which could affect their availability.

PHA Maintain Control

HUD requires PHAs to maintain control of properties, providing several methods by which to do so:

- holding a fee simple interest in the real property;
- being the lessor under a ground lease with the property owner;
- having direct or indirect legal authority to direct the financial and legal interests of the property owner with respect to the RAD units;
- owning 51% or more of the general partner interest in a limited partnership or of the managing member interest in a limited liability company with all power of a general partner or managing member;
- owning a lesser percentage of the general partner or managing member interest and holds certain control rights as approved by HUD;
- owning 51% or more of all ownership interests in a limited partnership or limited liability company and holds certain control rights as approved by HUD or;
- demonstrating other ownership and control arrangements approved by HUD.

A related option for developers is to be the operator of the property after conversion, rather than handing those duties over to a property manager. This allows PHAs to retain their management, maintenance and other staff. The alternative approach has been chosen by some PHAs whose cost structure may be prohibitive in managing a converted property, that is; the cost of salaries and the related burden of pension and other post-employment benefit costs do not allow the PHA to operate the property profitably. ❖

For more about RAD, purchase your copy of the 2023 Novogradac Rental Assistance Demonstration Handbook, available in January at www.novoco.com/products.

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