



Operating Subsidy Review Guidelines April 2014

GOAL: Most forms of operating subsidy¹ that support Low Income Housing Tax Credit (LIHTC) investments are derived from federal, state or local government funding sources. As a result, the risk of the continued availability of a particular subsidy is a function of government budgets, public policies and the political environment. These AHIC Operating subsidy Review Guidelines (“Guidelines”) provide a framework for how an AHIC investor might think about the positive and negative impacts of subsidies on transactions by helping an AHIC investor identify:

- General risk factors associated with operating subsidy programs;
- Methods for evaluating the impacts on project viability should an operating subsidy program be removed or materially diminished;
- Techniques for assessing the exposure a specific project may have to a particular operating subsidy program (i.e. sensitivities); and
- Options to mitigate the potential risks of an operating subsidy program.

To the extent an AHIC investor views an operating subsidy as having a positive impact on an investment’s overall risk profile, the risk of a reduction or loss of the subsidy can be viewed as “Program Risk.” Therefore, each section of these Guidelines begins with an introduction to explain the intent of the section in relation to subsidy risk and then includes general guidance to evaluate the potential risks.

Note: *These Guidelines are more qualitative than quantitative since individual AHIC investors must determine the appropriate mitigation (e.g., stress tests, debt resizing, guaranties, reserves, holdbacks, etc.) of risk based on their own perspective and risk tolerance. Furthermore, the Guidelines are intended for analyzing project-based (rather than tenant-based) operating subsidies that will support project operating expenses and/or debt service.² These Guidelines also only address concepts relating to key operating subsidies that are commonly seen by AHIC investors (e.g., Section 8, Public Housing Operating Funds, etc.) and thus may not address the risks relating to all rental subsidies involved in affordable housing. Lastly, these Guidelines are not intended to address additional tenant social service, supportive housing or similar subsidies that AHIC investors may identify as risks in their transactions.*

¹The term “operating subsidy” is meant to include only monetary support received by the LIHTC Partnership (owner) that either (1) augments a resident’s ability to pay rent (“rental assistance”), or (2) reimburses the Partnership for a development’s operating expenses relating to certain units.

²Project-based subsidies are contractually tied to a specific housing development. In contrast, tenant-based (also referred to as “mobile” or “portable”) subsidies are tied to a specific household and follow that household should it move out of the housing development (e.g., as with Housing Choice / “Section 8” mobile vouchers).

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Section I. Political Risk

Introduction: Sources of funds for operating subsidy programs are typically allocated (“appropriations”) and committed pursuant to contracts and programs that change over time as a result of a variety of factors external to the property or specific LIHTC transaction. While LIHTC underwriting presumes a 15-year investment hold period, often operating subsidies have explicit contract clauses making the continued availability of the subsidy conditioned on annual appropriations from a legislative body. Areas for an AHIC investor to evaluate to determine if a specific property is likely to survive in a changing programmatic environment may include Congressional budget appropriations, levels of public and/or political support, and whether proponents of a particular program hold positions of legislative leadership on key committees.

Evaluating the long-term viability of a particular subsidy type involves evaluating the relative strength and durability of political leadership committed to the program, the attraction of a particular type of subsidy or subsidy delivery mechanism in the context of broader policy initiatives, the program size (both by dollar amount and constituency), the budget environment in Washington, the particular agency involved in funding or administering the program, and other programmatic risks. This section is intended to help an AHIC investor discern the political factors that may influence this evaluation.

Areas of analysis for the AHIC investor to consider:

- 1. How deep is the affordable housing development, management, and finance industry involvement with the specific operating subsidy program? Who are the key constituencies of the program?*
- 2. What are the local, county and state politics behind the tenancy served (older adults, disabled, transitional housing, workforce, etc.)?*

3. *Is the operating subsidy program related to a legal mandate or other legal action implemented to ensure the tenancy is served? Set aside examples include NY/NY III in New York City and the Williams Consent Decree in Illinois. Another example is a tax levy dedicated by law, such as seen in King County, WA.*
4. *What is the current and projected level of budget support for the program in question? What have been the historical funding levels and observed trends (full funding, increasing or decreasing funding)?*
5. *At what level are the budget decisions made? At the executive or legislative level? Has that changed in past, current or future budget cycles?*
6. *What is the level of executive and legislative support for the specific program? Has there been any proposed or recently passed legislation affecting the program or agency involved?*
7. *Is there any pending litigation that could potentially affect the program?*
8. *Is the operating subsidy program a legacy program primarily affecting only owners/managers/investors from a pre-LIHTC program era and thus may have a smaller base of political support?*
9. *Is the program one that is particularly vulnerable to attempts to defund the program at the federal level or other applicable jurisdictional level?*

Section II. Location Risk

Introduction: As noted in the previous section, the commitment and allocation of operating subsidies is affected by the political, budget, social and market characteristics of the jurisdictions (city, county and state) in which the LIHTC development is located. This section focuses on how risk may be viewed differently in areas with high housing costs (rental costs as well as development costs, including land value and construction) and significant barriers to entry for new rental housing that have led to more political support for affordable housing and operating subsidies.

Note: *This section can be viewed as a subset of Political Risk in that the level of support for a particular program often directly reflects political concerns arising in part from rental market demand that significantly exceeds supply.*

Areas of analysis for the AHIC investor to consider:

1. *Is the property in a locality with a robust preservation or a free market political orientation? If the locality is preservation-oriented:*
 - *Are there local programs that might offer alternate rental housing assistance?*
 - *Has the judicial environment been factored into the re-tenancing sensitivity analysis? Certain court jurisdictions allow for tenant protections that make evictions to allow re-tenancing extremely difficult.*
 - *Are there local statutes that might otherwise prevent re-tenancing within the assumed timeframe or at the assumed post-transition³ rents? For example, do rent stabilization/rent control laws apply?*
2. *Does the degree of preservation-orientation in the city, county or state in which the development is located suggest additional resources might be made available should a subsidy be reduced or lost? Is there a history of the city, county or state providing any additional support to a development after closing (either pre- or post-stabilization)?*
3. *Could the locality's degree of preservation or tenant-protection orientation present roadblocks to implementing a transition plan? In addition to the potential judicial obstacles to eviction discussed above, have the political and social environments necessary for re-tenancing been adequately factored into the sensitivity analysis. For example, what is the extent of city, county or state hard and soft debt in the transaction, and what would be their practical political options in terms of allowing re-tenancing or assisting with tenant removal in the event of foreclosure to allow for restructuring of the development (see Section VI, Operating Subsidy "Overhang" and Section VII, Sensitivity Analysis for further discussion)?*

Section III. Property Risk

Introduction: This section focuses on a property's condition, which is defined as its physical condition and design, the attractiveness of its location, and the demographic characteristics of the current tenancy. The resulting marketability of a LIHTC property based on these factors can be a component in assessing the risk of the property's reliance on an operating subsidy. This

³In the event of a partial or full loss of subsidy, a transition or transition plan refers to removing tenants supported by an operating subsidy and replacing them with tenants who are able to pay full LIHTC rents without rental assistance.

section discusses how operating subsidy risk may be viewed when assessing the practical feasibility of transitioning a subsidized property to market rate or other uses should the rental operating subsidy be lost.

Areas of analysis for the AHIC investor to consider:

- 1. For a post-rehab property, is the post-rehab condition suitable for unsubsidized marketing or is the property functionally obsolete (even post-rehab) in the absence of a rental operating subsidy?*
- 2. For a new construction property, are the design, amenities and location appropriate for a conversion to maximum LIHTC rents or market rents if the operating subsidy were lost?*
- 3. Is the project 100% subsidized or is it mixed-income (i.e., is there a demonstrated capacity to operate at less than 100% subsidized)? Are there occupied market rate units that demonstrate marketability at unrestricted rents?*
- 4. How deep is the rent skewing (i.e., the percentage of the existing residents below 60%, 50%, 40%, 30%, 20%, 10% AMI) and what is the political/economic viability of existing resident relocation and new resident re-tenanting (e.g., do Federal Uniform Relocation or related Federal or State laws apply to relocation)?*
- 5. Do the applicable regulatory agreements allow for a conversion to higher LIHTC rents upon the loss of the operating subsidy? (See definition of Section VI, Maximum Achievable Rent, which incorporates this concept.)*
- 6. Besides hard debt, are there unavoidable (uncontrollable) operating costs likely to lead to quicker foreclosure (e.g., high real estate tax payments)?*

Section IV. GP/Developer and Guarantor Risk

Introduction: The desire of the general partner/developer (“developer”) to maximize its cash fee may lead to additional risk if the developer seeks to capitalize the contractual stream of operating subsidy by securing a higher amount of hard debt that is sized based on the subsidy. Further, the developer may have a concentration of various operating subsidies in his or her portfolio, particularly if the developer focuses on preservation/rehab transactions. On the other hand, the reliance on operating subsidy and the risk that presents to an AHIC investor may be mitigated by the developer’s experience and its staff expertise in seeking out additional subsidy and support. This section discusses the potential risks and rewards of operating subsidy

in light of the developer's experience. This section also weighs any risks against the guarantor and guaranties in the transaction.

Areas of analysis for the AHIC investor to consider:

Developer:

- 1. Is the developer sufficiently politically sophisticated to successfully navigate a scarce public resource environment?*
- 2. Do the developer, syndicator and property manager have broad and deep expertise in various subsidy programs (i.e., can they be expected to navigate a changing subsidy environment)?*
- 3. What is the depth of developer, syndicator and property manager experience with past operating subsidy appropriations and the programs' evolutionary challenges (i.e., LIHPRA, ELIPHA, Mod Rehab, S-8 Renewal, Mark-to-Market, Enhanced Vouchers, 236 Decoupling, mixed-income, market experience)?*
- 4. To what extent is the developer monetizing above-market Section 8 rents and transferring the overhang risk (see definition in Section VI) to the investor?*
- 5. Has the developer been required to retain adequate reserves in the transaction to fully mitigate overhang risk, or is there unmitigated overhang risk? If the latter, what is quantifiable (see Section VI) overhang exposure throughout the compliance period?*
- 6. Have the developer's guaranties been sized and extended through the compliance period in such a way as to mitigate the overhang risk?*
- 7. Have the guaranties been structured in such a way to align the interest of the developer with that of the investor to help ensure the long-term success of the project?*
- 8. Is the developer walking away with a full cash development fee payment prior to the compliance period while the investor assumes appropriations risk?*

Guarantor:

- 1. Does the guarantor have sufficient net worth and liquidity to address possible funding shortfalls?*
- 2. Is the guarantor's net worth and liquidity "overshadowed" by large contingent liabilities?*

3. *Do the guarantor's contingent liabilities have a low or high probability of being called on? Does an analysis of its REO schedule indicate properties are sufficiently performing and thus unlikely to result in calls on the guarantor's guaranty obligations? Are the poorly performing properties, if any, still under any guaranties? Are there operating reserves or other project sources to cover deficits and thus reduce the reliance on the guarantor's balance sheet?*
4. *Do the guarantor's other properties have a high exposure to the same or similar operating subsidies?*
5. *Would a significant portion of the guarantor's net worth (in terms of cash flow distributions and/or residual obtained from its LIHTC investments) be depleted should the operating subsidy be lost or reduced?*
6. *Is the guarantor's liquidity spread across a broad range of exposed projects via multiple contingent liabilities?*
7. *Does the Operating Deficit Guaranty ("ODG") extend through the compliance period? Is a separate subsidy guaranty appropriate given the level of overhang, appropriations and other subsidy risk?*
8. *Is the timing of the burn-off of the ODG and/or subsidy guaranty tailored to match the timing of the potential appropriations risk?*
9. *How far beyond stabilization do the ODG and/or subsidy guaranty extend? Are the terms and release hurdles sufficient given the amount the underwritten subsidy rents are above underlying achievable LIHTC rents (overhang)? Are they sufficient given the amount the contract rents are above comparable market rents in the area, particularly for Section 8 HAP Contracts that are subject to rent comparability tests?*
10. *Does the ODG and/or subsidy guaranty extend beyond "re-stabilization" assuming underwritten rent and expense growth and "achievable" LIHTC rents?*

Section V. Contract Risk

Introduction: This section addresses the terms and conditions of the operating subsidy contract that should be considered when determining the relative risk of a subsidy. These include the term of the contract, required annual appropriations, and the method of rent or expense reimbursement increases. In addition, this section addresses that operating subsidy contracts may be subject to program requirements or other factors outside the scope of the

written language of the contract. Further, the section addresses whether there is the ability for the Partnership (owner) to opt out of a program and re-tenant under certain circumstances.

Areas of analysis for the AHIC investor to consider:

1. *Does the term of the operating subsidy contract extend until or beyond the end of the compliance period (see Section VI, Operating Subsidy Overhang for “Contract Renewal Risk” definition)?*
2. *If not, has the underwriting taken into account the potential for non-renewal of the contract, re-tenanting and/or rent decreases upon renewal (e.g., for Section 8, market rent comparability/reasonableness requirements)?*
3. *Is the contract subject to annual appropriations or has the contract been fully appropriated via legislative or other processes?*
4. *If the contract is fully funded through a capitalized source within the transaction, does the capitalized amount match the subsidy revenue projected over the compliance period, including the projected annual rent growth (i.e., the 2% assumed income growth or other underwritten rate)?*
5. *Do the contract or program regulations contain sufficient “opt-out” mechanisms sufficient for re-tenanting if the subsidy is reduced or lost? How is a subsidy “reduction” defined, if at all? Does it include non-approval of rent increases by the program administrator that leads to flat rent growth and operating deficits over time?*
6. *Does the rent increase mechanism specific to the subsidy program tie to the underwritten rental growth assumptions? For example:*
 - *For project-based Section 8 HAP Contracts, do HUD Operating Cost Adjustment Factor (“OCAF”) or Annual Adjustment Factor (“AAF”) trends support the pro forma assumptions? Do comparable market rent trends support the assumption if the contract is subject to “Rent Comparability” tests? Is the contract an “Exception Rent” project that ensures a minimum contract rent? What is the history of budget-based rent increases for the project? Are there significant residual receipt accounts at the property that HUD may require to be used to fund rent increases?*
 - *For project-based voucher HAP Contracts, do the Public Housing Authority’s past and projected Fair Market Rent (“FMR”) payments standards support the assumptions? Do the comparable market rent trends support the assumptions, given the contract will be subject to Rent Reasonableness tests?*

7. *Has the underwritten rental growth assumption taken into account programmatic quirks? For example, OCAF and AAF annual net increases are based on the portion of the rent that does not support debt service, which is considered a fixed expense that does not need a corresponding increase in rent each year. So OCAF and AAF historical trends must be viewed in the context of the specific transaction since the OCAF or AAF percent increase will be granted on a pro-rata basis only to the portion of rent-supported, non-debt service expenses.*
8. *Have the developer and property manager been adequately underwritten with respect to HUD 2530 clearance risk relating to other parts of their portfolio/REO schedule? Are there properties with REAC score or other HUD problems that could affect pending or future HAP approvals for this transaction?*
9. *Has the underwriting adequately taken into account costs associated with specific program compliance (e.g., HUD REAC inspections, A-1 audits, etc.)?*

Section VI. Operating Subsidy Overhang

Introduction: This section will clarify the terms “Overhang” and “Debt Overhang” utilized in the current *AHIC Underwriting Guidelines*, dated November 2010. It will assist an AHIC investor in assessing the extent to which a LIHTC investment is reliant on operating subsidy. This determination will be based on a variety of factors, including the extent the pro forma subsidized rents are above the achievable rents in the unsubsidized/unrestricted market (“market rents”) and/or allowable LIHTC rents. Other key factors include the capitalization structure of the transaction, primarily the type of debt (hard or soft) employed and the extent to which hard debt payments are reliant on the operating subsidy.

Definitions: Although each AHIC investor will establish its own internal measurements of a property’s reliance on operating subsidy,⁴ this section provides syndicators and AHIC investors a common definition for the term “overhang,” since it has not been used consistently in the LIHTC industry.

Underwriting Analysis Grid (fillable, attached separately): Utilizing the definitions below, this grid will assist an AHIC investor in identifying specific underwriting information that should be

⁴ Individual AHIC investors will determine their own ‘burn off’ scenarios/sensitivities that reflect a loss of subsidy over time, such as under an assumption of prolonged sequestration.

obtained from the syndicator (or developer, for a direct investment) to aid in analyzing the investment's risks relating to operating subsidy.

- (1) Maximum Achievable Rent = The lesser of a unit's (1) maximum net allowable LIHTC rent, (2) maximum allowable rent under any other housing program applicable to the unit, or (3) Achievable Market Rent,⁵ as determined by a market analysis that is consistent with the *Model Content Standards* of the National Council of Housing Market Analysts (NCHMA).

Note: *If allowed by the applicable regulatory agreements, the Maximum Achievable Rent should take into account the ability to convert to higher LIHTC rent levels (higher Area Median Incomes or "AMIs") upon the loss of the operating subsidy.*

Note also that the "maximum allowable rent under any other housing program applicable to the unit" would only include the actual tenant-paid rent when such tenants could not legally be removed, even if their rental subsidy were to be lost and they were unable to pay the required rent. This concept would also apply in the event of the continuation of any special needs, senior or other set aside where the tenants could not afford the maximum LIHTC rent without the use of Section 8 mobile vouchers. In such cases, the Maximum Achievable Rent would likely be 30% of a tenant's projected Social Security Disability Insurance or Social Security Insurance income.

- (2) Operating Subsidy Income = The portion of the pro forma underwritten rent for each unit that (1) exceeds the unit's Maximum Achievable Rent and (2) is obligated by a governmental entity through a project-based subsidy contract.

Operating Subsidy Income may also be referred to as the "Overhang."

Note: *This definition excludes tenant-based subsidies, which will typically not be underwritten by investors or lenders. Further, this definition measures the differential between the subsidy rent level and the Maximum Achievable Rent, not the typically higher differential between the subsidy rent level and the actual rent being paid by the tenant (see "Annual Tenant Rent Deficit" and "Transition Adjustments" below).*

- (3) Annual Pro forma GPR = The base year annual Gross Potential Rents (Income) ("GPR") including all *Operating Subsidy Income* used in the underwritten lower tier pro forma.

⁵Presumably the comparable Maximum Achievable Rent determined by a market analyst (with sufficient rent advantage for the units to be competitive at the indicated rent levels). It is not the "average" market rent observed in the market area nor is it the maximum allowable LIHTC rents.

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(4) Annual Pro forma GPR at Maximum Achievable Rents = The base year annual GPR excluding any *Operating Subsidy Income*. For each unit type, this pro forma amount should reflect the *Maximum Achievable Rent*, as defined above. In other words, the *Annual Pro Forma GPR at Maximum Achievable Rents* is typically the GPR that would have been underwritten had there been no project-based operating subsidy agreement associated with the transaction.

(5) Annual Overhang = The difference between the (1) *Annual Pro forma GPR*, and the (2) *Annual Pro forma GPR at Maximum Achievable Rents*. If the *Annual Pro forma GPR* exceeds the *Annual Pro forma GPR at Maximum Achievable Rents*, the project is considered to have *Overhang* in its pro forma.

Note: *There are instances when this amount may exceed the amount of hard debt (i.e., when the Subsidy Income/Overhang is supporting operating expenses in addition to debt service). See also "Debt Overhang" below.*

(6) Overhang Y1-15 = The sum of the *Annual Overhang* for each year projected in the pro forma, from initial lease-up through the end of the Compliance period.

Note: *For this calculation, all pro forma assumptions regarding income (both tenant-paid rents and subsidy contract rents) and expense trending and vacancy rates must be disclosed.*

(7) Debt Overhang = The amount of hard debt supported by the Annual Overhang at the Lender's required conversion Debt Service Coverage Ratio (DSCR). This represents the amount by which the hard debt would need to be reduced to maintain the required DSCR at conversion⁶ if the operating subsidy contract were not in place.

Note: *If the permanent debt includes an ongoing DSCR covenant, the Debt Overhang should be calculated based on sizing the loan over 15 years to maintain the minimum DSCR covenant, rather than solely in the conversion year.*

(8) Overhang Deficits = The deficits (Annual or Y1-15) induced by substituting the *Annual Pro Forma GPR at Maximum Achievable Rents* for the *Annual Pro Forma GPR* in the modeled projections. The *Overhang Deficits* quantify how far below break-even (including provision

⁶Based on the underwritten rents and expenses in the pro forma budget (assuming no income or expense trending during the construction period).

for the payment of hard debt) a project will operate in the absence of the *Operating Subsidy Income*. *Overhang Deficits* will be less than *Overhang* when a transaction has been initially underwritten with an *Annual Pro Forma GPR* (which includes *Operating Subsidy Income*) that results in DSCRs⁷ reflecting sufficient free cash flow to absorb the loss of subsidy over 15 years. As an example, assume that a transaction is underwritten with a subsidy that results in a starting DSCR of 1.30x and increases to 1.50x by Year 15. If the full loss of subsidy on “Day 1” (immediately upon stabilization) results in a starting DSCR of 1.15x that increases to 1.25x by Year 15, that transaction has “*Overhang*” due to having a pro forma that assumes subsidy contract rents above *Maximum Achievable Rent* but does not have any “*Overhang Deficits*.”

- (9) Annual Tenant Rent Deficit = The sum of the annualized difference for each unit between the (1) *Maximum Achievable Rent* and the (2) annualized estimated average Tenant-Paid Rent. This definition assumes that upon the loss of the project-based operating subsidy contract, tenants previously covered by the contract will not receive Section 8 or other tenant-protection vouchers.
- (10) Transition Adjustments = The sum of projected temporary operating deficits net against structural expense changes specifically attributable to a transition of the property from one with *Operating Subsidy Income* to one without.

Note: *In addition to addressing the Annual Tenant Rent Deficit, the overall projected Transition Adjustments should also take into account assumptions regarding evictions, relocation and/or legal costs relating to the tenants who will no longer be able to afford rents without the operating subsidy. The deficits should also take into account additional transition period vacancy, re-absorption rates, re-leasing incentives and concessions, marketing and leasing costs, temporary staffing, etc. The point of evaluating Transition Adjustments separate from Overhang is to evaluate separately the components of the permanent net changes attributable to the drop in rents (the loss of the Overhang) versus the temporary deficits attributable to the transition to the new rent structure absent the operating subsidy contract.*

See **Appendix A** for calculation example.

- (11) Other Transition Operating Changes = There may be instances where underwritten pro forma income and operating expense levels are unique to a project with Operating Subsidy

⁷Or IER for a “no hard debt” transaction.

Income. An analysis of the extent of any Overhang exposure may reasonably include adjustments to the projections if those adjustments are (1) clearly disclosed and quantified, (2) supported by an analysis at least as rigorous as was performed for the initial underwriting, and (3) evaluate both decreases and increases that may occur.

Under the assumption of a loss of the operating subsidy, necessary changes to the base line projected pro forma income or expenses may include the following:

- Higher vacancy, slower lease up, and/or higher turnover rates due to units no longer being subsidized and thus both in direct competition with the market and having to attract a higher band of income eligibility;
- Additional advertising, marketing and/or leasing expenses necessary to attract prospective residents in the absence of market rent advantages offered by the lost subsidized rents;
- Reduced administrative staff as a result of reduced compliance requirements upon loss of the Operating subsidy contract;
- Reduced real estate tax expenses if the applicable jurisdiction calibrates taxes owed based on GPR or EGI (which may be lower as a result of reductions in overall GPR upon the loss of subsidy); and/or
- Slower rent trending if unsubsidized *Maximum Achievable Rents* are expected to grow more slowly than the subsidy contract rents (e.g., past growth trends of maximum LIHTC AMIs/Rents may reflect slower growth rates than those for a project-based Section 8 HAP Contract's past OCAFs or a project-based voucher HAP Contract's past Fair Market Rent payment standards.)

Note: *Other Transition Operating Changes* may fall into dramatically different time periods. Some (e.g., advertising expenses) may extend over only a short re-absorption period while others (e.g., real estate tax expense adjustments) may extend from transition through to the end of the compliance period. Best practices suggest that the time period be included in each adjustment item to highlight temporary versus long-term structural adjustments.

(12) Renewal Risk = Projects that receive project-based operating subsidy contracts with terms that do not extend through the compliance period risk face contract renewal risk. This is the risk to the AHIC investor that the contract will not be renewed by the subsidy provider

upon expiration or will be renewed under contract rents and/or terms that are less favorable to the AHIC investor than the original contract and pro forma assumptions.

Contract renewal risk can be calculated by applying the same Maximum Achievable Rent, Annual Overhang and other calculations noted above (as well as *Other Transition Operating Changes* as defined above) at the start of the pro forma year in which the contract expires and projecting the resulting deficits through the compliance period.

Areas of analysis for the AHIC investor to consider:

Rent Underwriting:

1. *Have the underwritten Achievable Market Rents been derived from appropriate comparable properties without operating subsidies? Were unrestricted market comparables from the HUD Rent Comparability Study or PHA Rent Reasonableness Study reviewed? Was the Primary Market Area (PMA) from which the comparables were selected appropriate in location and size?*

2. *How do the Achievable Market Rents compare to the:*
- *HUD FMRs for the applicable area;*
- *Average Market Rent in the PMA; and*
- *Subject's underwritten subsidy contract rent?*

Is there a risk that the subsidy contract rent could be viewed as substantially above the Achievable Market Rent, the FMR and/or the Average Market Rent and thus could be adjusted downward or held flat by the subsidy provider in the future under the terms of the contract and/or program regulations?

3. *Have the underwritten Achievable Market Rents been adequately substantiated (i.e., by a third-party using NCHMA standards)?*

4. *Are the underwritten subsidy contract rents at or above Achievable Market Rents or is there at least a 10% rent advantage (i.e., the contract rent is at least 10% below the Achievable Market Rent)?*

5. *Does conversion to an unsubsidized rent structure result in projected 1.0x DSCR or above over the compliance period? Or are there projected deficits?*

6. *What is the Subsidy Debt Overhang? To what extent would paying down the debt, if allowed, reduce these deficits (i.e., are the deficits primarily related to debt service or do the underwritten contract rents also cover other operating expenses)?*
7. *Has the market study adequately addressed functional obsolescence in the property masked by the existence of current rental assistance? Could the development compete in the market as an unsubsidized LIHTC property in the absence of rental assistance?*

Debt Underwriting:

1. *Does the transaction's capitalization structure include hard debt?*
2. *Does the amortization schedule of the hard debt (or a tranche thereof) match the term of the subsidy contract?*
3. *How quickly would the property be in monetary default in the absence of subsidy or no annual rent increases?*
4. *If there is not a separate transition reserve, is the operating reserve sufficient to cover "regular" operating deficit risk and "transition" risk, or is there "double dipping" of the pledged security to cover multiple operating risks?*
5. *Are only contingent soft debt payments at risk in the event of loss of subsidy?*
6. *Are any of the hard or soft lenders affected by a default triggered by a loss of subsidy? Are any of the lenders units of government economically responsible for loss sharing on the hard debt in the event of default (e.g., HUD / FHA mortgage insurance) and thus may have an incentive to allow forbearance or complete a workout to avoid foreclosure?*
7. *Are any of the project lenders involved in other capacities? For example, is the lender an agency that is also serving as the HAP Contract administrator or participating in a HUD risk-share first loan?*
8. *Is the subsidy provider also serving as a lender (hard or soft), general partner or guarantor? If so, they will have incentive to ensure the provision of subsidy to ensure they are not removed as general partner and/or have operating deficit obligations.*

9. *Are any of the lenders (hard or soft) unaffiliated with the subsidy provider or owner of the Subject transaction preservation-oriented? If so, they may be incentivized to direct additional resources to preserve repayment of their soft debt, particularly if foreclosure of the first lien loan would remove their soft loan restrictions and “wipe out” their subordinate lien.*
10. *Is the real estate taxing authority (or a subsidiary or affiliated entity) involved in the deal as general partner, co-general partner, ground lessor, HAP administrator, right of first recipient, etc.? Has the syndicator assumed lower real estate taxes due to a lower assessed value under a direct capitalization approach in the absence of subsidy? If the taxes are based on rental income under a payment in lieu of taxes (PILOT) agreement, taxes should be reduced under a loss of subsidy stress test if the subsidy contract rents exceeded Underlying Achievable Rents.*
11. *If HUD/FHA-insured debt is involved, as part of its Subsidy Income Overhang calculation has the syndicator adjusted the base case underwritten reserve deposits (e.g., reducing \$800 per unit per year replacement reserve deposits to a lower amount)?*
12. *Are there built-in excess reserves in real estate taxes, insurance or other escrow accounts that remained in the deal but that might be eligible for discretionary release in the event of a loss of subsidy? Is there a large residual receipt account (HUD “New Regulation” Section 8 transaction) that potentially could be approved for use to stabilize the property upon loss of a subsidy contract?*

Section VII. Structural Protections

Introduction: The risk of a LIHTC investment’s reliance on operating subsidy, as measured by Subsidy Income Overhang and Subsidy Debt Overhang, can be mitigated by various structural protections in the transaction. The intent of this section is to provide the tools for an AHIC investor to determine the appropriate protections, which may include capturing net available cash flow, establishing additional operating and transition reserves at the property and/or fund level, and ensuring appropriate guaranties at the property and/or fund level.

Areas of analysis for the AHIC investor to consider:

Property Level:

1. *Is underwritten cash flow sufficient without the use of operating reserves in the absence of appropriations issues?*
2. *Has the underwriting assumed use of operating reserves for uses other than appropriations risk (i.e., double-counting operating reserve as a mitigant for other risks)? Is there a separate subsidy/transition reserve provided to solely cover appropriations and renewal risk?*
3. *Is there sufficient equity held back both in terms of dollars and in terms of timing of release, particularly to ensure execution of the subsidy contract at the underwritten rents?*
4. *Is there sufficient equity/cash developer fee held back to mitigate loss of subsidy (including if loss of subsidy occurs after last earn-out)? Or are these equity hold-backs spoken for to fund reserves, achieve permanent conversion, fund construction costs, mitigate inadequate hard/soft cost contingencies, etc.?*
5. *Is the operating reserve used prior to or after the ODG? If the former, internal structural protections/security to offset subsidy risk may be gone before the investor realizes the guarantor is unable to meet its financial obligations under the ODG.*
6. *Is the guarantor obligated to restore the operating reserve prior to ODG release? If the operating reserve can be used prior to reaching the ODG cap, is the operating reserve used pari passu with the ODG (thus aligning general partner and investor limited partner interests in solving problems)?*
7. *If replacement reserves, operating reserves and/or transition reserves are looked to as mitigants for overhang risk, who controls their use? Does the investor have approval rights for use of such reserves?*
8. *Are there residual receipts accounts that might be discretionarily made available by HUD in an appropriations shortfall scenario (i.e., HUD "New Regulation" Section 8 residual receipts accounts)?*
9. *Are there other project attributes that might amplify the risk of the loss of operating subsidy (e.g., elevated leverage).*

Fund Level:

1. *Is the portion of the upper-tier property needs reserves allocable to the investment reasonable relative to the magnitude of overhang risk?*
2. *Is the fund structured such that the upper-tier property needs reserves draw down to such an extent that they may not be available to mitigate overhang risk in the later years of the compliance period?*
3. *Is the scale of the overhang risk deemed manageable – that under a worst-case scenario, a limited unscheduled capital contribution from the investor could protect credits and avoid recapture without substantially impacting economics?*
4. *Are there any additional reserves (beyond the property needs reserves) at the fund level that are set aside for the Subject property to specifically address the subsidy risk?*

Section VIII. Sensitivity Analysis

Introduction: This section identifies additional factors an AHIC investor may wish to consider when determining what sensitivities could be used to assess operating subsidy risk and the adequacy of various structural protections.

Areas of analysis for the AHIC investor to consider:

1. *Has the syndicator adequately modeled the sensitivity analysis for loss of subsidy?*
2. *Will termination or non-renewal of the specific subsidy trigger automatic tenant eligibility for Section 8 enhanced vouchers?*
3. *If tenant voucher eligibility is a mitigant that is included in the syndicator's transition analysis, are appropriations cutbacks for these vouchers a risk in a scarce public resource environment?*
4. *If the property is functionally obsolete (uncompetitive in the market place) without subsidy, has the syndicator assumed a conversion to unachievable rents without physical improvements? And if physical improvements are contemplated, has a designated source that is not used as a mitigant for another risk been identified for those improvements?*

5. *Has the syndicator modeled a reasonable transition period specific to the locality? For example, in a judicial “pro-tenant” eviction and foreclosure environment (pro-preservation locality), transition will likely take time.*
6. *Has the syndicator assumed reasonable transition rents (the appropriate Maximum Achievable Rents)?*
7. *Are the rents upon transition reasonable given the current tenancy and given any future tenancy required under any set-aside (e.g., special needs/supportive housing) requirements that remain despite the loss of operating subsidy?*
8. *Does the transition plan adequately address issues, including costs, associated with “rebranding” the Subject property from a “subsidized” or “Section 8” property to a “regular LIHTC” property? Has the syndicator adequately accounted for marketing, leasing, advertising, vacancy and bad debt loss, etc. during the conversion process?*
9. *Are the general partner and property manager capable of successfully managing a three-phase transition process (i.e., do they have any demonstrated capacity to manage the transition from a project-based operating subsidy development – to a mixed-income development – to a straight LIHTC development)?*
10. *Has the syndicator adequately considered other restrictive covenants that might prevent the project from migrating to achievable comparable market rent under Section 42? In other words, has the syndicator fully assessed the Underlying Achievable Rent, which may be controlled by HOME, other soft financing or inclusionary zoning restrictions that are more restrictive than the maximum allowable LIHTC rent?*
11. *Has the Syndicator factored in the impact of a reversion utility allowance in its determination of the transition rent? For example, upon the loss of a HUD subsidy and applicable HUD utility allowance, the corresponding PHA or utility company allowance applicable to the Underlying Achievable Rent may be higher than the HUD allowance.*
12. *Was the appropriate rental growth rate assumed for the sensitivity analysis? For example, although a 100% Section 8 pro forma may utilize a 2% growth rate based on 2.5% average 5-year OCAF growth trends in the area, the 5-year LIHTC rent growth for the area may be only 1%. The investor should consider that the transition sensitivity assume a LIHTC rent growth rate lower than 2.5%.*

13. *Has the syndicator factored in the need for greater market rent advantage during the period of conversion (i.e., >10% rent advantage necessary until the project exceeds some threshold ratio of subsidized to unsubsidized tenant mix)?*
14. *For multi-investor fund transactions, in the event of a failure of the project to survive transition, what is the overall impact on the fund (aggregated deficits to Y15, overall reduction in IRR, reduced credit delivery, total recapture risk) in the event of foreclosure, and at which periods in time?*
15. *In the event of a failure of a specific program, is the above magnified in the overall fund portfolio by multiple projects with the same or similar programmatic exposure?*

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APPENDIX A

Transition Deficit Calculation Example

BR	A No. Unit	B Max Net LIHTC	C 10% Below Achievable Market Rent	D Lesser of B or C	E Subsidy Contract Rent	F Tenant Paid Rent	G A*(E-F)*12	H A*F*12	I G+H	J A*D*12	K I-(A*D*12)	L I-K-H
				"Maximum Achievable Rent"			Subsidy Portion = Annual Overhang	Tenant Paid Portion	Annual Pro Forma GPR	Annual Pro Forma GPR at Maximum Achievable Rents	Annual Overhang	Annual Tenant Rent Deficit
1	20	\$700	\$800	\$700	\$1,000	\$50	\$228,000	\$12,000	\$240,000	\$168,000	\$72,000	\$156,000
2	20	\$800	\$900	\$800	\$1,200	\$75	\$270,000	\$18,000	\$288,000	\$192,000	\$96,000	\$174,000
3	20	\$900	\$1,000	\$900	\$1,400	\$100	\$312,000	\$24,000	\$336,000	\$216,000	\$120,000	\$192,000
	60						\$810,000	\$54,000	\$864,000	\$576,000	\$288,000	\$522,000

(1) Annual Tenant Rent Deficit Portion

Assumed Total Re-tenanting Period: 20.0 Months
 Assumed Turnover to Maximum Achievable Rent: 3.0 Units Per Month
 5.0% Turnover Per Month
 36.0 Units Per Year
 \$725 Weighted Tenant Deficit Per Month
 Using Column K above

Month	Deficit	Month	Deficit	Month	Deficit	
1	\$43,500	13	\$23,506	25	\$0	
2	\$41,325	14	\$22,330	26	\$0	
3	\$39,259	15	\$21,214	27	\$0	
4	\$37,296	16	\$20,153	28	\$0	
5	\$35,431	17	\$19,146	29	\$0	
6	\$33,659	18	\$18,188	30	\$0	
7	\$31,976	19	\$17,279	31	\$0	
8	\$30,378	20	\$16,415	32	\$0	
9	\$28,859	21	\$0	33	\$0	
10	\$27,416	22	\$0	34	\$0	
11	\$26,045	23	\$0	35	\$0	
12	\$24,743	24	\$0	36	\$0	
				Total:	\$558,117	Deficits for Months 1-36

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(2) Annual Overhang Portion

Assumed Total Re-tenanting Period:	20.0	Months
Assumed Turnover to Maximum Achievable Rent:	3.0	Units Per Month
	5.0%	Turnover Per Month
	36.0	Units Per Year
	\$400	Weighted Overhang Per Month
		Using Column J above

Month	Deficit	Month	Deficit	Month	Deficit	
1	\$24,000	13	\$12,969	25	\$0	
2	\$22,800	14	\$12,320	26	\$0	
3	\$21,660	15	\$11,704	27	\$0	
4	\$20,577	16	\$11,119	28	\$0	
5	\$19,548	17	\$10,563	29	\$0	
6	\$18,571	18	\$10,035	30	\$0	
7	\$17,642	19	\$9,533	31	\$0	
8	\$16,760	20	\$9,056	32	\$0	
9	\$15,922	21	\$0	33	\$0	
10	\$15,126	22	\$0	34	\$0	
11	\$14,370	23	\$0	35	\$0	
12	\$13,651	24	\$0	36	<u>\$0</u>	
				Total:	\$307,927	Deficits for Months 1-36

Summary of Projected Transition Costs	Assuming 20 Month Transition Period
Annual Tenant Rent Deficit Portion	\$558,117
Annual Overhang Portion	\$307,927
Other Transition Operating Costs(Example Estimate / <u>Not</u> Calculated Above)	\$200,000
Total:	\$1,066,044