AHIC
AFFORDABLE HOUSING INVESTORS COUNCIL

UNDERWRITING GUIDELINES

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*Additional resources listed here are available on AHIC's Website

INTRODUCTION

These Underwriting Guidelines can be used as an outline for an underwriting process and for investment documents for proprietary, multi-investor, and direct investments in low-income housing tax credits (LIHTC). They examine how to analyze the financial strength and expertise of the development team; the key points to understand the sources and uses in the development budget; critical facets of underwriting the deal; best practices in due diligence; and tools for reviewing the capacity of syndicators.

Members of the Affordable Housing Investors Council have developed this resource for informational and educational purposes only. Nothing contained here should supplant individual analysis by an investor. Nor should it be construed as mandating any particular deal term.

While the Guidelines can be used to identify and mitigate risks associated with individual transactions, following them will not necessarily lead to successful projects. The multiple dimensions of real estate success or failure are intertwined and complex.

A note on the language used in this document. The operating tier entity that actually owns the relevant LIHTC development may be a limited liability company, in which case the operating tier agreement would typically be called an "operating agreement" and the entity in control would be called a "managing member." Alternatively, the operating tier entity may be a limited partnership, in which case the operating tier agreement would typically be called a "limited partnership agreement (LPA)" and the entity in control would be called a "general partner." While there are legal differences, they are not important in this context. For simplicity, the discussion will assume a limited partnership is used.

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I. DEVELOPMENT TEAM

A development team with the appropriate expertise and capacity is essential to the success of a housing credit project. Every member of the team needs to have the relevant experience and financial and organizational strength to deliver its contribution to the endeavor. Below are key areas that investors should explore for each entity.

A. Developer

The developer should have experience with similar developments or create a team that has relevant experience. **AHIC recommends that a developer have experience with at least five LIHTC or affordable multi-family rental developments that are comparable in size and complexity.** Because of the developer's crucial role, **the limited partnership agreement should not permit a substitution of the general partner without the consent of the investor.**

In instances where a co-developer relationship relies on one or the other of a development partnership having explicit LIHTC (or other specialty) experience, underwriters should consider whether withdrawal/removal of the partner with LIHTC experience should be added to the project documents as an explicit trigger for non-monetary default. The underwriter should also determine that there are clear roles and responsibilities for each co-developer and understand the working relationship and history between the entities (i.e., if there are market concerns and/or complex set-asides, will the experienced partner be in place through stabilization or will it exit following construction completion?).

If the developer or co-developer is an affiliate of a syndication firm, ensure that the deal was negotiated on an arm's length basis and that deal terms are customary and consistent with terms in that market.

WARNING: If a syndicator-affiliated developer's deal is selected for admission post fund closing, pay particular attention to related-party conflicts of interest and consider requiring that the syndicator obtain a third-party due diligence review prior to deal admission.

When evaluating the developer (or development entity, where an affiliate of the general partner is utilized) consider the following:

- **Geographic Reach** – Identify the headquarters and regional offices of the proposed developer and whether it has:
  - An established track record in the state
  - Adequate understanding of the specific market and/or submarket for the proposed development
  - A robust commitment to any new state being proposed (i.e., can it exit that state without the same consequences as terminating business in its home state?)
  - Expanded into a new state to avoid reputation issues from a prior state
  - A long-term geographic strategy that makes sense for the developer in the context of its business operations
  - Other applications in the proposed state
  - A plan to manage and staff the project from a distance if it is outside its current region(s).

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- **Developer Background** – Conduct background checks on the developer, including lien and litigation searches, **no sooner than 45 days prior to lower tier closing.** Additionally, consider if applicable whether updated background checks should be commissioned prior to upper tier closing, based on the length of time the property has been warehoused. For developers and guarantors, updates to background checks may be done periodically (annually) for compliance violations, arrests, bankruptcies, lawsuits, or other pertinent information. The frequency of ongoing background checks may be driven by an investor's internal credit policy and may taper off after credit delivery. Common sources of background information include Lexis/Nexis, internet search engines, bankruptcy court filings, and, if liens, judgments, or lawsuits surface, investigative services reports. Some investors perform an investigative services report for all new relationships. **Keep in mind any relevant Know-Your-Customer, Anti-Money Laundering, and Volcker regulatory requirements.**
- **References** – Obtain references from lenders, allocating agencies, other investors, and professionals who have prior experience with the developer. Typical questions include:
  - **Lender** – Amounts/terms of borrowing lines including permitted uses of letters of credit as well as covenants and triggers, amounts/terms of loans outstanding, payment histories, delinquencies, and workout resolutions
  - **Allocating Agency** – History of recapture, adjusters, credits returned back to the agency, and uncured 8823s
  - **Other Investors and Syndicators** – History of prior experiences
  - **Professionals such as Attorneys, Accountants, Architects, and Engineers** – History of prior experiences. While direct investors often contact professional references, in some instances it is sufficient that the developer provide the references as a measure of the quality of its professional services relationships. If a background investigation raises concerns, investors should contact some or all of the professional references.
- **Site Visits** – Conduct site visits of completed units in projects previously completed by this developer for others as part of new developer review.

WARNING: A developer with a successful track record completing 40-unit, new-construction garden apartments may not be qualified to undertake a complicated historic rehabilitation. A developer whose expertise is constructing and managing 100% Section 8 properties may be unable to make a smooth transition to market-rate development. A developer of rural projects may run into difficulty tackling an urban inner-city transaction. Accompany any stretching of capacity with a thoughtful analysis of why the underwriter believes the developer is qualified to undertake the new format. If the developer is weak or untested, discuss the specific mitigants in place to address that weakness.

- **Organizational and Financial Capacity** – Determine whether there is sufficient management, staffing, and financial capacity, and confirm the developer's ability to manage growth. Investors should review the developer's:

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- **Pipeline** – Analyze the developer's latest pipeline in the context of the developer's staffing level, giving particular attention to the development stages of each project; ideally, the pipeline will consist of developments in various stages of planning and completion; focus on the operating and financial strength of the portfolio (e.g., debt service coverage, occupancy, and cash flow)
- **Current versus Prior Workloads** – Compare the number of projects anticipated for the current year with development activity in prior years: if a significant increase is noted, understand how the developer plans to manage the additional workload (e.g., have staffing levels increased over time in response to increased volume?)
- **Project Status** – Determine if the developer is experiencing delays or cost overruns, as this could be a sign its capacity is stretched

Financial Commitments – Understand the developer's outstanding guarantees and contingencies relative to its financial position (i.e., net worth and liquidity)

Staffing – given the 15-year investment horizon, understand the developer's staffing level, including any immediate concern around succession planning

Track Record – Understand the developer's prior track record in delivering projects on time and on budget and maintaining its operating performance; if the track record deviates significantly from industry benchmarks, understand why.

- **Financial Entanglements** – If the general partner is a non-profit, evaluate the organizational structure and economics of the transaction to ensure there are no private inurement concerns (i.e., the nonprofit's funds are sufficiently devoted to charitable purposes as defined by the IRS and individuals involved with the organization will not benefit directly or indirectly).
- **Role in the Transaction** – If the development received a tax credit award via the non-profit set-aside, evaluate the organizational documents to confirm that the non-profit general partner is materially participating in the transaction.

WARNING: When reviewing a general partner's role in prior transactions, pay attention to the particular responsibilities for each project. A red flag may arise if the developer has a lengthy list of projects, but scrutiny uncovers that the prior role was limited to being a financial or development consultant.

- **Vertical Integration** – If a development entity has an affiliated/related party property management company or general contractor, perform additional due diligence to detect potential fraud, abuse, conflicts of interest, and/or non-competitive terms.
- **Less Experienced Developers** – Instances where inexperienced developers are proposed need to be carefully evaluated and additional measures taken to mitigate the risk. If the entity has fewer than the preferred five transactions in its portfolio, evaluate:
  - The **collective resumes** of a new development company for the joint prior experience of its leaders
  - **How long the syndicator/investor has been partnering with the developer,** the extent to which they have received technical assistance, and the number of joint applications for subsidies and/or credits submitted
  - If the inexperienced team is augmented with a **tax credit consultant,** review the contract for services: it should bind the consultant to the developer, and replacement or removal of the consultant should require approval of the syndicator/investor; examine the consultant's record:

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- » **Working with this particular developer** and other less experienced developers; check references from state allocating agencies and local government entities
- » **Supporting deals** within the applicable state, city, and neighborhood market
- » **Submitting applications** for affordable housing developments and the number of successful awards.

For additional AHIC resources related to evaluating developers, see the AHIC Disclosure Form and AHIC Real Estate Owned (REO) Schedule.

B. Guarantor

Guarantees are only as good as the guarantors who make them. As noted below in Section III.C. Guarantees, the suitability of the guarantor is directly related to the nature of the guarantees being provided. Investors need to determine whether the guarantor has the appropriate resources and is legally bound to fulfill its specific obligations by examining the following:

- **Background Checks** – Conduct background checks on the guarantor, including lien and litigation searches, no sooner than 45 days prior to closing. Additionally, consider if applicable whether updated background checks should be commissioned prior to upper tier closing based on the length of time the property has been warehoused. Some investors include background checks for spouses of guarantors; however, banking and credit regulations may constrain who can be included in background checks.
- **Guarantor's Financial Capacity** – Determine the entity's ability to cover guarantee obligations through:
  - **A review of financial statements** (preferably three years of audited financial statements), tax returns, and current contingent liability schedules, with the most recent information dated within 12 months of closing
  - **Verification of the schedule of real estate owned (REO),** whether affordable or market rate, home ownership, vacant land, commercial, etc.; the REO schedule should provide details including property performance (portfolio performance of not less than 1.10 debt service coverage), construction and/or leasing status, debt service, and general partner share of cash flow (see AHIC's REO Schedule.)
  - Considering that in instances where the guarantor is viewed as inadequate or presenting specific risks, it may be possible to **negotiate a particularly tight construction contract and/or general contractor** bonding to mitigate some risks typically associated with the construction period
  - If the assets are jointly held, **considering including the spouse as guarantor** in case of divorce
  - If the REO schedule identifies subsidized properties in the guarantor's portfolio, **determining the potential impact of a reduction or elimination of those subsidies** on the guarantor's financial wherewithal; even if the guarantor is not obligated under a specific subsidy loss guaranty, s/he may be obligated under a tax credit recapture or other guaranty to fund ongoing operations
  - When a transaction's guarantors include an entity as well as the individual who owns the entity, ensuring there is **no double counting of net worth** (i.e., deduct the value of the entity from the individual's net worth).

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- **Liquidity** – The guarantor should have sufficient liquidity and net worth to provide financial support and cover guarantee obligations based on the size and scope of the project. AHIC recommends:
  - **Minimum net worth should be the greater of $5MM or 25% of total development costs**
  - **Minimum net liquid assets should be the greater of $1MM or 5% of total development costs**

    Liquid assets include cash, cash equivalents, and assets that can be converted to cash in a short time with little or no loss in value, including U.S. treasuries, mutual funds, money-market funds, and stocks; however, if a significant portion of the liquidity is tied to stocks, it is important to consider whether the value of these securities has changed materially since the date of the financial statements; retirement accounts should be excluded from the liquidity calculation due to penalties associated with early withdrawals **(all submissions should include verification of liquid assets)**
  - Construction liquidity of 15% for new construction and 25% for rehabilitation projects (construction liquidity is calculated as the sum of (1) cash development fee held back until 100% completion, (2) hard cost contingency, and (3) guarantor liquidity divided by hard cost construction costs); **when guarantor liquidity is excluded from the construction liquidity calculation above, AHIC recommends liquidity of 12% for new construction and 20% for rehabilitations**
  - If these minimum requirements are not satisfied, implement **additional safeguards** such as development fee holdbacks, cash reserves, and Letters of Credit securing the guarantee obligations, or a combination of these.
- **Obligations to Underperforming Assets** – For non-performing assets within its portfolio, the guarantor must disclose the extent of its financial obligation (both actual and contingent). Developments requiring funding should be described in enough detail to identify whether or not the developer/guarantors have met their obligations as provided under each project's operating agreement. Instances where the obligation has been voluntarily exceeded should be disclosed and instances where the obligation has not been met should be explained. The analysis of underperforming assets should address the sufficiency of liquidity relative to the cash needs of the troubled projects. The guarantor should outline both the relationship between contingent liabilities and how the scale and scope of contingent liabilities on underperforming assets compares to the scale and scope of the guarantor's liquidity. Evaluate in each case whether the developer/guarantor is acting as a reliable counterparty.

WARNING: Where material portions of the REO portfolio are non-performing, pay particular attention to what caused the issues, whether those issues arose as a result of action or inaction on the part of the developer, and how the developer or guarantor plans to fund deficits and/or cure nonperforming issues.

- **Legal Authority** – Secure a legal opinion or obtain an authority certificate and/or resolutions to confirm that the guarantor has the authority to make the guarantee.
- **The Nature of the Guarantor Entity** – Guarantees may be provided by individuals or by corporate entities, either operating companies or single-purpose entities (SPEs).
  - **Personal guarantees** are preferable, and **usually most effective in ensuring compliance with the guaranteed obligations,** since they place an individual's assets at risk.

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- **Operating companies** are corporate entities typically engaged as going-concern businesses organized to perform specific purposes (e.g., development, property management, construction, real estate investment, or some combination of businesses). **Guarantees from operating companies are generally preferable to those provided by SPEs** because its key principals are less likely to abandon it as a mechanism to avoid guaranteed obligations, since doing so would put the operations of their other business at risk. In addition, guarantees from operating companies are typically viewed more favorably than those from SPEs since an underwriter can obtain several years of audited or reviewed financial statements, tax returns, and, in some cases, references and bank statements. Review financial statements with an eye towards "following-the-money" to gain a credit-oriented understanding of the dynamics affecting the entity. Factors to consider include why the entity was established; how the corporation is structured; the number and duration of projects pledged to it; history of revenue streams such as developer fees, management fees, incentive fees, and cash flow; future activities planned; what other business risks and opportunities are likely to impact the entity in the future; and potential contingent liabilities. Note that S Corporations can be particularly hard to underwrite and analyze, as it can be difficult to determine how and when revenues are distributed and what corporate earnings are retained.
- **Single-Purpose Entities** are corporate entities employed as mechanisms to legally and financially isolate key principals and/or parent companies from liabilities (including those associated with the guarantees being provided). They may have less robust histories and financial documentation than operating companies and may therefore be challenging to evaluate along the lines described above. Consider limiting the number and amount of guarantees to be provided by this SPE and capitalize the SPE with appropriate cash reserves and springing guarantees. Because it is easy for a guarantor to pull funds out of an SPE, **the guarantee agreement should include minimum net worth and liquidity requirements that remain in place during the compliance period.** Calibrate the amounts according to the specific risks in the transaction.

C. Property Manager

Property management firms should have at least 10 years of property management experience and at least three years of Section 42 or related affordable housing experience. A new manager should be teamed with a manager experienced in Section 42 compliance. Evaluate LIHTC property management experience, including Section 42 training and compliance procedures and tenant review policies. Additionally, determine the company's experience in the particular market/region and with relevant deal characteristics, including special needs tenancies and subsidy contracts. Property managers should supply information about any 8823s, including a description of the ultimate outcome (cure or recapture) and REAC scores on their properties. Review the firm by undertaking the following:

- **Conduct Site Visits** to properties currently under management and review tenant files.
- **Ensure Current Compliance Accreditation, Training, and Experience.** Pay attention to whether the person responsible for technical compliance matters (associated with the specific asset) carries the requisite accreditation.
- **Perform Background Checks** with state allocating agencies. Property manager background checks including lien and litigation searches are not as uniformly performed as those for developers and guarantors. If pursued, they should be made no sooner than 45 days prior to closing.

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- **Obtain References** from developers, other investors, and lenders. At a minimum, property managers should provide references for prior projects that are similar in scale and scope to the proposed project.
- **Obtain a Schedule of Real Estate Managed** to determine the number of properties under management, including housing credit properties/units, and the operating performance of the portfolio.
- **Review Annual Financials** for the property management firm for the past 3 years.
- **Determine Related Party Status** and, if the property manager is an affiliate of the developer, require subordination of property management fees to support below break-even operations. This will help to mitigate the risk profile of the transaction and to align the interests of the GP/Property Manager/Guarantor. **A removal of the GP should also allow for the automatic termination of the affiliated property management company, at the investor's discretion.**
- **Evaluate the need for on-site management.** Typical considerations include the number of units, the local market, and the needs of any targeted population. If on-site property management is not provided, determine how an off-site manager will manage the property.
- **Determine Qualifications of Consultants.** If a compliance consultant has been engaged due to the property manager's lack of adequate experience, examine its suitability, including when it was established, experience of the principals, number of properties/units it has consulted on, and the length of time the consultant will be providing services to the subject property (through initial qualified occupancy or ongoing throughout the compliance period).

D. General Contractor

The general contractor (GC) should have experience with similar projects and show clear evidence of the ability to complete this development on time and on budget. The following due diligence can help an investor explore the GC's capacity and expertise.

- **Review a backlog and list of current projects,** including percentages of completion, to identify potential financial and capacity issues.
- **Examine plans, specifications, and the construction contract** for completeness, deliverability, and price feasibility. If the underwriter lacks the internal architectural and engineering resources to adequately review construction, retain a third party (e.g., engineering firm, architecture firm, and/or internal construction administration group if available).
  - **Multi-investors** – Where investors rely on a syndicator to perform due diligence on the adequacy of construction documents and budgets, the investor will need to understand if the syndicator's internal staff are qualified to make the evaluation. If not, the investor may want to engage third parties for additional architectural and engineering diligence.
  - **Proprietary** – Investors in proprietary funds can expect to be drawn into more in-depth discussions regarding what level of construction due diligence is warranted under the specific circumstances (e.g., reducing scope for repeat developers, leveraging plans and specifications from previously completed projects, or increasing scope where the investor is also the construction lender).
  - **Direct** – Direct investors may need to evaluate the cost-benefit of increasing head-count to employ architectural and engineering professionals on staff versus contracting for such services from third parties.

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- **Conduct background and/or reference checks** – General contractor background checks, including lien and litigation searches, are not as uniformly performed as those for developers and guarantors. If pursued, they should be made no sooner than 45 days prior to closing. In the event that background checks are not performed, at a minimum the general contractor should provide references for prior projects that are similar in scale and scope.
- **Evaluate the contractor's bond or letter of credit** – The general contractor should (1) **provide a payment and performance bond for the full construction contract** amount that is issued by a nationally, financially recognized bonding company (AM Best A-9) in a form acceptable to the investor or, (2) **secure a letter of credit in an amount equal to at least 15% of the total amount of the construction contract** from an acceptably rated lender. Any waiver of bonding requirements should be accompanied by an analysis of the risks and mitigants associated with accepting that variance. Note that bonding companies will typically not bond contractors affiliated with the developer. When related-party GC entities are utilized, un-bonded GC affiliates are typically acceptable only if:
  - Major subcontractor bonding is obtained
  - The guarantor is particularly credit-worthy
  - The participants have a successful track-record with the developer/general contractor
  - Additional developer and general contractor fee holdbacks are negotiated
  - Personal completion guarantees are included
  - An evaluation is performed covering:
    - » The amount of investor equity at risk through the period of time typically covered by a bond
    - » The amount and type of work being performed
    - » The nature of the relationship with subcontractors.

WARNING: Fixed-sum construction contracts combined with a payment and performance bond provide the double protection of a predetermined price and an insurance policy to access in the event of financial/construction problems. Related-party general contractors that lack bonding capacity typically rely on the financial capacity of a guarantee from both parties (in which case credit underwriting of those entities becomes paramount). Because bonding of the major subcontractors typically occurs late in the development process, if this is pursued minimal investor equity should be paid in before sufficient subcontractors have been "bought-out" at prices consistent with the development budget and the project is on track to arrive at completion with sources and uses balanced.

- **The Structure of the Construction Contract** – Construction contracts are typically structured as guaranteed maximum, cost-plus, or fixed-price arrangements. Payment should be structured on a draw request basis with retainage, and penalties for slippage are common in deals where timing is tight. Regardless, timing penalties are typically not viewed as being as effective as completion guarantees backed by strong guarantor entities. Cost-plus/guaranteed maximum price contracts often provide better insight into the costs and process involved in the construction period. However, they are not as effective in containing construction costs as in the case of fixed-price contracts. In the case of fixed-price arrangements with related-party general contractors, lien waivers and cost savings accrue to the benefit of the general contractor only and are potentially more opaque.

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- **Where Contingency Funds are Held** – Determine whether construction contingency funds are included in the stipulated sum or guaranteed maximum price amount within the construction contract. A construction contingency held outside of the contract is preferable since it is controlled by the owner rather than the contractor; however, factors to consider when the contingency is included within the contract are whether the general contractor is affiliated with the developer and/or guarantor and whether the syndicator/investor has approval rights over use of the funds.

WARNING: Where construction timing is particularly tight (or tax credit deadlines resulting in loss of allocation are of particular concern), the diligence team should review the contract and tie the building delivery schedule back to the lease-up/adjuster assumptions. If the contract doesn't incentivize on-time performance, attention should be paid to the mechanism used to align the GC's interest in completing work in accordance with the projections.

- **Explore Related-Party Entities** – Apply special consideration for general contractors affiliated with the developer.
  - Ensure terms and conditions of the construction contract are arms-length.
  - Consider higher retainage or deferral of a portion of the profit.
  - Require cost certifications/audits of subcontracts.
  - Explore whether to seek the general contractor as a guarantor.
  - Assess the availability of subcontractors in tight labor markets. Evaluate the general contractor's track record and experience in the development's specific market. In the event it is less established, review the company's strength (e.g., internal staffing, access to resources, previous business done with subcontractors) to determine if the risk of delays resulting from labor shortages is acceptable.
  - Consider the involvement of non-profit partners for purposes of sales tax rebates on construction materials.

WARNING: In cases where the developer and general contractor are related entities, investors should confirm that the contract and all construction costs are and will be open to all parties for verification of funds utilized for construction. Some investors require that all payments to/contracts with affiliates over $15,000 be disclosed not only at closing, but also during the 15-year compliance period.

E. Other Development Team Professionals

Other professionals play key roles in ensuring a smooth development process.

- The **architect** should be licensed and have experience with similar projects.
- The **CPA or financial advisor** should be experienced with IRC Section 42.
- **Legal counsel** should be experienced with IRC Section 42. Any law firm issuing tax opinions should be a nationally or regionally recognized firm with appropriate expertise.

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II. DEVELOPMENT BUDGET

Sources and uses of funds in the development budget must balance to avoid financing gaps. It is important to evaluate the status of commitments for all sources and the assumptions driving all uses. **The developer should represent and warrant that it has provided a true and correct copy of the sources and uses and that it is materially consistent to sources and uses information provided to other participants (e.g., allocating agencies, lenders).**

A. Sources of Funds

There are myriad sources of funds in a housing credit development, and it is important to understand the extent of the commitment and the terms and conditions for each. Sources can include:

- **"Hard" debt** that is secured by the real estate and must be paid
- **"Soft" loans** that are payable by cash flow; investors should have a clear understanding of the compliance requirements for each lender, what constitutes a default under the contracts/loan agreements, and the appropriate rights, cures, and remedies
- **Grants** are typically not repayable or are only repayable if covenants pertaining to the award of the grant are breached (e.g., additional affordability or service-delivery requirements); perform tax analysis to determine if these grants must be considered as income
- **Developer equity** represents a portion of the developer fee that is deferred—it can be included as a source if the entire developer fee is included as a use; the cash portion of the developer fee can be used to offset guarantor obligations as long as the developer fee payout is structured so that most of the fee is paid at completion or later (i.e., is available and held by the limited partner until the time potentially needed)
- **Net Operating Income (NOI) or Cash Flow from Operations** from a property during lease-up or a tenant-in-place rehabilitation project (prior to permanent loan closing/conversion) may be included if acceptable based on the type of project and leasing assumptions; note that underwriting NOI or Cash Flow from Operations as a Source of Funds places further stress on the cash developer fee and guarantors in the event cash flow does not materialize.

WARNING: If NOI during construction is included as a source, it is typically prudent to discount revenue by some measure beyond a normal underwritten vacancy factor. Even if there is an historical basis for a property collecting a particular amount of revenue, historical precedent cannot always be relied upon when construction work may be disruptive to residents and critical amenities such as elevators or pools are periodically taken off-line. Account for off-line units or buildings in the projections. For new construction, if construction-period income is being included as a source of funds, ensure that the schedules for building delivery and certificates of occupancy are reasonable. Additionally, for both rehabilitation and new construction properties, the cash development fee holdback through completion and/or stabilization should be evaluated relative to the NOI amount included as a source to determine if there are adequate holdbacks to fund a shortfall in this source, particularly when considering other potential deal risks.

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B. Uses of Funds

All major categories of uses of funds should be identified, including acquisition, financing, construction, contingencies, reserves, developer fee, and other soft costs.

- **Construction loan interest, financing fees, and start-up expenses** should be accounted for in detail.
- **Construction hard costs should be a minimum of $25,000 per unit.** Lower costs per unit may be considered as long as the scope of work addresses the remaining useful life of all fixed, depreciable assets and delivers appropriate quality for the market. A third-party capital needs assessment should be used to review the adequacy of the construction hard cost budget. (See Due Diligence Section IV.F. Construction Review.) The third-party capital needs analysis should also discuss the adequacy of the replacement reserve, and annual contributions to it, in light of the remaining useful life of all the fixed assets.

WARNING: Rehabilitation budgets of less than $15,000 per unit, or an amount insufficient to provide a 20-year life of structures and major systems, may be inadequate to protect a LIHTC investment. If a developer can demonstrate evidence of upgrades having been performed historically, it may be possible to factor those existing conditions into the construction scope. Alternately, if some building systems have remaining useful life and don't require immediate replacement, "credit" for that remaining life could be factored into the adequacy of the replacement reserve calculations. In those instances, the specific inflated cost and timing of the replacement of the indicated items should be included in addition to the generally underwritten level of replacement reserve requirements.

- **Contingencies** should be based on the experience of the developer and general contractor, the type of project, and underwriting of other budget items.
  - **Hard cost contingencies typically range from 5% for new construction to 10%-15% for rehabilitation projects. Historic rehabilitation/ adaptive reuse projects may require higher contingencies up to 20% of hard costs.**
  - **Soft cost contingencies range from 2-3%,** depending on whether fees have been negotiated and fixed prior to closing.

WARNING: Unused contingency may have a negative impact on qualified basis and ultimately reduce tax credits, unless the project has adequate excess basis. Project documents should contain a requirement for expending remaining unused contingency funds at or around completion. Timing relating to the use of remaining contingency funds should take into consideration whether there are outstanding material construction risks occurring early enough for contingency funds to be spent on basis-eligible costs to support the tax credit allocation, as permitted by the agency.

- **Total developer fee** (as capped by the allocating agency) should be included in the budget with a notation regarding deferred developer fee.

WARNING: It is a best practice for the syndicator or direct investor to reconcile the underwritten sources and uses with other funding sources. When reconciling sources and uses among various participants (including the allocating agency), pay particular consideration to disclosure of developer fees payable.

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III. DEAL STRUCTURING ANALYSIS

A. Operating Projections

Because of the duration of a LIHTC investment, it is crucial that developments be underwritten with solid operating assumptions. Groundwork done at this stage to compare, test, and trend a developer's operating figures is key to ensuring the overall financial stability of the project and the soundness of an investment in it.

Operating projections should be based on and compared to information obtained from various sources including similar properties in the developer's, syndicator's, property manager's, and/or investor's portfolios, as well as data provided in third-party reports (such as an appraisal/market study/expense comparability analysis) and other real estate sources, such as the Institute of Real Estate Management (IREM), CohnReznick's online operating expense database, or the National Apartment Association (NAA). For acquisition/rehabilitation transactions, 1-3 years of historical operating results are a key resource for evaluating the new underwriting.

1. Revenue Analysis

Investors should perform sensitivity analyses on revenue trending assumptions (e.g., instead of 2% trending on rents, review historical rent increases and AMI/OCAF trending, trend at 1% or 0% based on the historical trending analysis and trace the impact through the investment hold period). Base year rents (budgeted rents agreed upon at deal closing) and expenses should be trended upward to the start of leasing, which is typically 12-18 months following commencement of construction. Market conditions and forecasts can assist in determining base year assumptions.

- **Unit Rents** – To determine competitive advantage and positioning, and whether there is a cushion available to increase rents when necessary, unit rents should be compared to maximum allowable LIHTC rental rates and to rental rates at similar existing market and LIHTC properties. Rents should also be compared with similar properties in relevant portfolios. **In order to have a competitive rent advantage, proposed rents should be at least 10% below achievable market rents and within the range of existing LIHTC properties.** If available, compare to achievable tax credit rents per the market study.

WARNING: When evaluating proposed rents, review the figures by unit type to see if any particular unit configuration has differentials materially lower than the floor of a 10% advantage. Market rents can be determined from a third-party appraisal, a market study and/or due diligence analysis, which often includes rental adjustments to comparable properties based on project quality, proposed amenities, or location.

- **Rent Comparables** – When comparing proposed rents to nearby LIHTC properties, note that maximum allowable LIHTC rents at different properties with the same Area Median Income (AMI) restrictions may differ within the same county due to (1) "Special HERA Projects" under the 2008 Housing and Economic Recovery Act (HERA) and (2) HUD's elimination of the hold harmless policy at the county level in publishing annual Section 8 incomes. Stress test rents over the 15-year period.

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- **Area Median Income (AMI) Trends** – Investors should analyze AMI and fair market rent (FMR) trends for the market for deals at or close to maximum LIHTC rents. Note that the hold harmless rules could hold rents flat while qualifying incomes decrease, resulting in tenants paying more than 30% of their income on rent. The Novogradac Affordable Housing Resource Center has a Rent Income Limit Calculator.

WARNING: Properties with rents at the LIHTC maximum may experience tightening of cash flow if area median income or FMR (in the case of rental assistance-subsidized properties) does not increase enough to allow for projected increases. If operating expenses escalate, and/or utility allowances rise at a rate that causes maximum allowable rents to decline, then the feasibility of the project can be jeopardized.

- **Rent Escalations** – Standard rent escalations are generally 2%. **Rent escalations should be at a minimum 100bp below operating expense escalation for the 15-year compliance period.** Watch how incomes inflate according to relevant sources, and then decide whether to allow rents to inflate. Rent trending may not be appropriate in areas where AMIs remain flat or FMRs are projected to grow at less than 2%, as discussed above.

WARNING: Some states may use other rent escalations (e.g., California is at 2.5%). Evaluate these non-standard levels carefully.

- **"Other Income"** – Revenue from sources such as laundry and parking should be reasonable and comparable to other properties within the region and the developer's portfolio. Only include items that are recurring, defensible, and voluntary to the tenant (e.g., do not underwrite rent late fees and other charges). If underwriting an acquisition/rehab project, other income should be supported by historical operations.
- **Market Rate Income** – **Most investors prefer that there be no more than 20% of income coming from market rate units,** and some are prohibited by their institutions from considering investments that exceed this threshold. Examine if retail/commercial income is contributing to market rent dependent income and run a sensitivity analysis at 60% AMI rents for the market rate units. Inquire about the existence of any units rent-restricted above 60% that are neither market rate nor LIHTC. Because market rate units will compete against other market rate properties in the market, examine whether the development offers either a comparable set of amenities or a discount in rents to compensate for the difference. Additionally, due to the potential risks associated with market rate units in mixed-income properties, **a minimum 10% discount to achievable market rents for all unit types, including the market rate units, is considered prudent.** When assessing the risk from mixed-income developments, consider the experience of the developer, the property management company, and the site manager with market-rate tenancies, and review actual collected market rents from previous phases or the developer's nearby properties as evidenced in a rent roll.

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Mixed-income projects are appealing from a community development standpoint and many have proved successful operationally. However, because of the additional risk involved, focus should be given to local market demand, the history of similar projects, and the shared tenant populations being considered. Revenue from the non-LIHTC units will likely support operating expense and debt service coverage, which makes their underwriting critical to the success of the project. **Mitigants may include broader income eligibility bands, using at least a 10% vacancy assumption on the non-LIHTC units, underwriting the market rate units with at least a 10% discount to area market rate rents, and sizing debt at a maximum of 60% of AMI for the market rate units.** Some investors are sensitive to the extent to which their tax credit equity is going to finance costs that are not generating tax credits (and for which they are not participating in the cash flow) and assuming market rate risk for non-market rate returns.

- **Commercial Income** – Projects may have commercial space owned by the project and leased to private parties. Some project general partners lease the commercial space from the partnership for a fixed rate and then lease the space to individual private parties, a structure typically referred to as a "master lease." An investor may rely solely on the creditworthiness of the master lessee (the general partner-related tenant) or may want comfort as to the creditworthiness of the commercial space subtenant or the overall marketability of the space at underwritten rents should either the subtenant and/or master lessee fail to meet their obligations.

  Many investors will not rely on commercial income to size hard debt and will require commercial space to be legally separate and excluded from the LIHTC partnership agreement. However, if used to size hard debt, commercial income should be (1) less than 20% of total income, (2) underwritten at a higher vacancy rate than the rental income, and (3) assumed to be let at a rate less than the local commercial market. Include tenant improvement allowances upon lease renewal in underwriting. Income projections from existing commercial tenants should consider any costs at lease renewal or subsequent vacancy of the space. These costs should include the costs of tenant re-leasing (tenant fit-up costs, brokerage commissions, and lost revenue during turnover), and should be included in the financial projections based on market normal lease terms. Commercial space operating expenses should also be explicitly accounted for and not assumed to be covered as part of normal residential operations. Market conditions usually dictate what share of commercial tenant expenses are born by the tenant or by the owner. Terms such as triple net or expense stops should be explicitly explained relative to owner obligations for paying management fees, common area maintenance expenses, replacement reserves, and property taxes.

  A qualified third party should determine market rents and vacancy rates for the commercial space and an analysis should be included in the market study for the project. For existing commercial tenants in acquisition/rehab deals, review the leases to determine the businesses' viability over the investment period. Examine the guarantor's financial capacity in light of assumptions around commercial income.

  While properties with commercial space can be structured to minimize the investor's risk by either having a separate partnership own the commercial space or by having a creditworthy entity master lease the space for the duration of the compliance period, the risks associated with the attractiveness of the property if the space is vacant or leased to an undesirable business remain. Investors should ensure that the syndicator/investor has approval rights over tenants occupying the space.

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WARNING: Strategies for managing the risk associated with commercial income can include: (1) not allowing an Operating Deficit Guarantee to burn off completely; (2) deploying a master lease structure; (3) establishing a separate guarantee for commercial income; and (4) having a separate entity (that does not own the housing credit units) own the commercial space.

- **Rental Subsidies** – Most forms of operating subsidy that support 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. AHIC has developed Operating Subsidy Review Guidelines to provide a framework for how an investor might think about the positive and negative impacts of subsidies on transactions by helping 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; and
  - Options to mitigate the potential risks of an operating subsidy program.

The Operating Subsidy Review Guidelines include an Operating Subsidy Underwriting Analysis Grid. It can be used to calculate the "overhang" exposure if Section 8 rents are in excess of the maximum allowable tax credit rents.

- **Vacancy Rates** – Vacancy rates are **typically underwritten at 5% - 10%. Projections may vary based on the proposed tenant profile, with seniors at the lower level of the range and families at the upper end.** Assumptions should be justified based on market conditions as verified by third-party reports. A minimum 7% vacancy rate is customary, though a vacancy of 5% is generally acceptable if supported by subsidy or a 3-year prior operating history, as well as favorable demographic and market trending. Some investors utilize 2% over the LIHTC average per the market study. Investors should be mindful of vacancy assumptions for properties with a small number of units, since one or two vacancies can have a significant impact on property operations.

2. Expense Analysis

Expense assumptions should be based on comparable property figures, preferably audited, from the developer, property manager, and/or syndicator. **It is essential to ensure the reasonableness of the comparable properties used in terms of location, age, number of units, tenancy type, construction type, design, etc.** If available, tap third-party reports such as a market study, and other real estate resources such as IREM or NAA. For acquisition/rehab transactions, historical operations should be used to evaluate the current underwriting on projects with a critical review of any cost savings proposed by the developer. Consider running sensitivity at historical cost average with no cost savings.

Due diligence should be performed on certain key individual expense line items. Developers should provide documentation to support specific line item expenses such as insurance quotes and post completion tax estimates from tax assessors. Investors should seek confirmation from the property management company that the operating expense per unit number presented by the developer is reasonable for the project, including the administrative and staffing assumptions, which should include provisions

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for payroll and other taxes as well as benefits. Additionally, to ensure comparability of expense data, adjust for annual inflation (generally 3% per year) to arrive at the underwritten stabilized year (i.e., if the expense comparable data is based on 2017 audits and the base year operating expenses are for 2019, the comparable data should be inflated twice by 3% per year or 1.03^2).

For multi-phase projects, expense projections may be lower on a per unit basis due to economies of scale and shared amenities or staffing. Since each project may need to operate individually, investors should not underwrite these shared expenses (e.g., landscaping contract or shared maintenance staff), and, instead, should underwrite the project as a "stand-alone" project.

WARNING: Investors should be cautious as to assumptions used in expense projections. Expense projections may reflect expected economies of scale based on the developer or property manager's overall portfolio. A critical eye should also be given to any expense "savings" associated with an acquisition/rehabilitation development, with sensitivity analyses performed without these savings. Pay particular attention to projects where the rehabilitation budget is low, yet there is a sizable reduction in repairs and maintenance expenses assumed in the operating budget. Often these savings are not realized, especially in the case of a minimal scope of work, ultimately creating stress on the project's long-term operations. Confirm that any assumed reductions are consistent with the work being performed.

- **Escalations** – Expense escalations should be **at minimum 1% above income escalations for the compliance period.** Standard expense escalations range from 3%-4%. Investors may want to consider separate trending assumptions for certain line items, such as utilities, real estate taxes, and management fees.
- **Real Estate Tax Exemptions and PILOTs** – if underwriting less than a tax assessors' computation, perform due diligence at the city, county, and state levels. Depending on investor comfort levels with the certainty of a proposed exemption, some investors are underwriting to the higher level of taxes and sizing debt accordingly. If including a real estate tax exemption, some investors are requiring an unlimited Operating Deficit Guarantee stay in place for the full compliance period to cover the assumed tax exemption.

WARNING: When a development is in a county with a recognized challenge to a local assessment law, or an assessor is being challenged frequently, the investor should request an assessor's comfort letter or legal opinion. Under the circumstances, in the absence of one of those two items many investors would not include the benefit of PILOTs or exemptions.

- **Property Management Fees** – Even if the management firm is affiliated with the developer, these fees should be included in expenses because a third party may have to be engaged in the future. **Property management fees are generally between 4-8% and in no case more than 10% of total net income, with a minimum requirement of $25-$30 per unit.** Related party property management fees should be underwritten based on market rates in case a change in the management company is required in the future.

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- **Green Building Features** – Investors are typically not underwriting utility cost savings due to inclusion of energy-efficient technologies and are including the costs and training required for appropriate technology maintenance. Any proposed utility savings should be justified by the specific relevant factors, such as system installations, life cycle costs, training, parts availability, monitoring/maintenance contracts, and utility rate trends.
- **Social Services Costs/Expenditures** – If tenant services are required per the tax credit application, investors should underwrite the social service provider and make certain that the budgeted costs are sufficient to provide those services over the 15-year compliance period. Some investors will also require a social service reserve.

B. Reserves

Adequately sized reserves are the investor's insurance policy for planned and unplanned expenses that cannot be covered from cash flow. Ensuring the appropriate level of reserves is crucial for maintaining the overall financial health of the property/fund. During peak LIHTC markets, there can be a tendency for downward pressure on reserve levels. If pressed for deviations from standard reserve requirements, investors should explore mitigants that can be put in place or determine if there other factors that reduce the risks associated with lower reserves, such as market conditions, the strength of the developer, and the debt burden on the deal.

Typical reserves include the following:

- **Interest Reserves** should reasonably cover construction period financing costs.
- **Lease-up Reserves** support operating costs during leasing, prior to stabilization/permanent loan conversion.
- **Operating Reserves** are maintained by the developer to fund future cash flow shortfalls and should equal **at least 6 months of total operating expenses, replacement reserves, and must-pay debt service (OERDS).** They should be **funded by capital contributions as soon as possible after construction completion and remain in place for the duration of the 15-year investment period.** Draws above a certain dollar amount should require consent of the investor/syndicator. **The reserves should be fully replenished by the sponsor or through available cash flow from the property prior to release of the operating deficit guarantee (see below) or distributions to the developer.** When underwriting operating reserves, it is important to perform a stress test to determine the financial impact of construction or lease-up delays. Operating reserves can also be stress tested by performing a sensitivity analysis on the trending assumptions used over the 15-year compliance period, and determining the "break-even point" for the transaction. If the sensitivity analysis reflects negative trending of the debt service coverage ratio, investors may require additional reserves or guarantees to mitigate that risk.

WARNING: Supportive housing developments that serve special needs populations require specialized underwriting that examines particularities associated with these transactions around items including tenant services, reserves, guarantees, and rental income. They typically have an additional social services reserve that is sized to the terms of the deal. (See Due Diligence Section IV.I.4. Supportive Housing.)

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- **Replacement Reserves** are funded annually from project operations to cover ongoing capital needs for the life of the project. **For new construction developments, AHIC recommends a minimum of $250 per unit per year for projects with senior tenants and $300 per unit per year for projects with family tenants, adjusted for inflation. For rehabilitation projects, higher levels are typically required based on a capital needs assessment.** Additionally, higher funding levels should be considered for single-family home developments and properties serving special needs tenancies. For both new construction and rehabilitation deals, replacement reserves that are capitalized in the development budget and funded can be used to account for a ratable portion of ongoing replacement reserve requirements. The annual replacement reserve contribution should be inflated by 3% per annum; otherwise, there should be a greater initial capitalization and/or higher annual contribution amount to account for the lack of an inflation factor over the compliance period.
- **Section 8 Reserves** may be sought in the event that the Project-Based Section 8 contract has a Section 8 overhang issue. The size of the reserve depends on the magnitude of the overhang and the amount the project can bear. Refer to AHIC's Operating Subsidy Underwriting Analysis Grid.
- **Upper Tier Reserves** for multi-investor funds serve to limit the likelihood of additional capital calls beyond investors' initial commitments. As such, investors should look for a structure that funds all anticipated fund costs and provides some level of capital for unforeseen project needs. AHIC Guidelines recommend three distinct reserves as noted below and further discussed in the AHIC Upper Tier Reserve Guidelines.
  - **Asset Management Reserves** are sized to fund the costs of asset managing the projects over the life of the fund.
  - **Fund Expense Reserves** are sized to fund the annual expenses of the fund (i.e., annual audit preparation, tax return preparation, etc.).
  - **Property Needs Reserves** support the operational needs of underlying projects and are a final resource available to support project operations after property level reserves and guarantees have been fully expended.

WARNING: Investors might consider increasing a fund's proposed property needs reserve if a significant number of specified underlying properties have been structured with weaker operating reserves (e.g., less than 6 months coverage; early release provisions) or operating deficit guarantees (e.g., less than 6 months coverage; less than 5-year term from stabilization; limited to no performance release provisions). Similarly, if any state allocating agencies have capped or eliminated reserves, consider requiring a compensating amount of reserves at the upper tier.

- **Other Reserves** can be established to mitigate a specific risk (e.g., a permanent loan re-sizing reserve or a guarantor liquidity reserve).

C. Guarantees

Guarantees are a complement to reserves in mitigating risks from unanticipated events and/or poor financial performance by the development. The guarantee should be drafted so that 1) it is triggered by a general partner default under any obligation to fund under the limited partnership agreement; 2) the guarantor may be granted a reasonable period of time to cure the default; and 3) the investor retains all remedies including joint and several action against both the guarantors and the general partner. The guarantee should be obtained from a financially sound entity,

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which may be other than the general partner if it does not have the requisite financial strength or is a single-purpose entity with limited assets. (See Development Team Section I.B. Guarantor.) Guarantees typically include the following:

- **Construction Completion/Development Deficiency Guarantee** should be unlimited through completion, run through stabilization/conversion to permanent financing, and not be repaid as a loan.
- **Operating Deficit Guarantee** (ODG) is negotiated depending upon project and developer variables. A minimum threshold amount or capped amount should be considered and is **typically sized to 6 months OERDS. During the ODG period, investors may require that the GP or Guarantor fund deficits under the ODG prior to draws on the operating reserves,** especially in the case of a weak guarantor. Investors may require a supplemental ODG to cover potential future deficits related to deal specific features, such as potential revocation of a real estate tax exemption or reduction of an operating subsidy. The ODG will generally burn off or be fully released during the investment hold period after three to five years of stabilized operations and once certain conditions have been met, such as:
  - One to two consecutive years of a 1.15 DSC ratio (ranges from 1.05-1.20) or 1.10 expense coverage ratio;
  - Fully funded/replenished operating reserves;
  - Operating subsidies, if any, in place;
  - Real estate tax abatement or PILOT, if applicable, in place; and
  - Payables fully paid.

WARNING: When considering something other than the standard 6-month operating deficit guarantee, alternatives to explore include whether the ODG should be the greater of 1 year of expenses or 1 year of debt service (especially for 4% deals where the debt service may be particularly large) or whether a better approach may be to size it based on total hard debt divided by the number of units.

- **Tax Credit and Recapture Guarantee** should match the initial compliance and credit recapture period of 15 years, and include amount recaptured, interest, and penalties. The guarantee should be unlimited in amount and payable via a general partner advance rather than from property cash flow at any point during the compliance period. Investors should be mindful of carve-out provisions excluding certain events other than a change in the Internal Revenue Code or transfer of the limited partnership interest.
- **Repurchase Obligation** requires the general partner to purchase the equity interest of the investor with a payment equal to capital contributions paid, an additional 10%, and reasonable costs (less benefits received to date) if a project fails to qualify for tax credits or one or more of the following events occur:
  - Significant changes in the tax credit delivery (i.e., 15-year versus 10-year delivery period);
  - Failure to meet the final closing requirements of the Partnership, often including break-even operating performance, permanent loan conversion, receipt of 8609;
  - Significant (e.g., 10% or greater) change in qualified basis;
  - Construction delays are in excess of three to six months or the placed in service date is not achieved;

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- Project does not achieve placed in service date by end of second year following the credit allocation year;
- Project will qualify for less than 70% of anticipated tax credits;
- Unacceptable delivery or invalidity of carryover allocation and/or IRS Form 8609;
- Sources of funds identified at closing are withdrawn and comparable commitments are not received within a reasonable period, but in any event within 90 days;
- Project fails to get Part 3 approval for historic tax credits; or
- Default.

D. Financing

Property financing should be identified and committed prior to investment, or suitable mitigants (e.g., an obligation for the general partner to secure alternative funding sources) should be in place. Leverage represents one of the biggest threats to equity ownership of any partnership, as a sponsor default on a loan to the development can lead to foreclosure. Therefore, investors must carefully examine the amount, terms, and underwriting assumption underlying all financing and secure cure rights on all hard debt.

- **Permanent debt** should be based on current (base) year rents with no trending of rents during the construction period. At conversion to permanent financing, **the DSC test should assume the lesser of (1) underwritten or (2) actual rents, and the greater of (1) underwritten or (2) actual expenses.**

WARNING: While a loan term of at least 15 years is ideal, loan terms and/or amortization periods that are too long could lead to an out-sized permanent loan. This could affect the "refinancing" of debt after the tax credit hold period and result in problems during disposition of the investment.

- Fixed-rate financing for a full 15 year term is preferred. Floating rate financing structures expose the underwriting to the risk of interest rate fluctuation. Swap-to-fixed and other synthetic fixed-rate structures expose the underwriting to the risk of credit-quality of the swap counterparties. Accordingly, floating rate debt and/or swap structures are not preferred and, if proposed, should explicitly address interest-rate and/or counterparty risk, as appropriate.
- **Debt service coverage (DSC)** – Cash flow from operations should provide **sufficient cash to cover "must pay" hard debt service at a minimum level of 1.15:1 or, in the case of tax-exempt permanent hard debt and mixed-income properties, 1.20:1.** If not, capitalized operating reserves should be sufficient, when combined with cash flow, to bring the deal to 1.15 or 1.20. If a project has no hard debt, an Expense Coverage Ratio (ECR), which is an expense to income ratio should be used. **An ECR of no less than 1.10 is recommended.** Ideally, the property's operating margin should increase over time; however, properties with a higher ratio of expenses to income tend to have a lower amount of hard debt and experience a declining DCR (or ECR). If the property is projected to operate at or near break-even levels (or with operating deficits) in later years, the adequacy of property reserves to fund potential shortfalls at such time should be evaluated.

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- **A forward lock** on a permanent fixed rate should be secured at closing to remove interest rate risk and possible downsizing of the permanent loan, which would create a financing gap and potentially have an impact on the amount of cash developer fee available for adjusters. The expiration of the forward lock should include a cushion to allow for a permanent loan conversion delay if there are construction and/or lease up delays. Another approach is to have a 3- or 6-month extension on the construction loan maturity, with the permanent lender's forward lock continuing in the event of an extension.
- **If floating-rate debt** is employed, a program of 15-year caps, swap, or other rate protection mechanisms should be in place at deal closing. Pay particular attention to the hedge provider's rating. For a tax-exempt bond deal, ensure that the swap or other hedge applies to the outstanding bond balance if bonds are being amortized at a slower rate than the loan and the partnership is responsible for interest on the outstanding bonds.
- **Permanent financing** should include performance-based conversion requirements (i.e., a minimum occupancy and debt service coverage ratio for a period of time) and a resizing provision. However, some loan types, including HUD 221(d)(4) loans, do not have such provisions, which increases the risk of the property being unable to support the permanent debt upon conversion. It is particularly important to consider the underwritten rent and operating expense levels in these cases. Existing tenants in place (in the case of occupied rehabilitations) and conservative operating expense projections are helpful in mitigating some of this risk.

E. Capital Contributions

Capital contributions are paid upon the achievement of certain conditions specified in the limited partnership agreement. The percentage of total equity paid at each funding depends on the sponsor's experience and financial strength, deal terms (e.g., size of construction contingency, amount of developer fee held back), project risks, availability of other funding sources, targeted internal rate of return, and other financial hurdles. The timing, benchmarks, and amount of individual capital contributions can be used to manage risks associated with construction, leasing, and financing.

- Benchmarks for capital contributions often fall into several or all of the following broad categories:
- Closing/admission to the partnership
- During construction at a percent of construction completion (i.e., 25%, 50%, 75%)
- Construction Completion and Certificate of Occupancy
- Stabilization (e.g., 6 months at 1.20x DSC and 90% occupancy), including conversion of loans to permanent financing
- Receipt of 8609

Any (or all) of the above benchmarks may also include a "not before" date (e.g., payment to occur the later of completion or June 30, 2017). **This "not before" date is used to protect the investor's yield from being diminished by the payment of capital contributions significantly earlier than projected at closing.**

Enough equity should be held back in the final installment (or the installment in which the downward adjustor is applied) to cover possible downward adjustors, especially if deal risks include a tight development budget, no excess eligible basis, or an aggressive construction schedule. (See Deal Structuring Analysis Section III.G. Credit Adjusters.) Similarly, enough equity should be held back in the permanent loan conversion installment to backstop any reduction in the permanent loan. This helps mitigate the challenge of collecting capital from a developer/guarantor if an adjustor or guarantee obligation is triggered. AHIC recommends at minimum a 25% holdback until Stabilization/8609s, with pay-ins during construction commensurate with amounts expended to ensure construction is not under-sourced. Generally, this final holdback amount will be principally cash developer fee.

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F. Developer Fee

The size, payment, and basis determination of the developer fee are affected by regulatory, tax, and deal structuring considerations. The developer fee payment schedule should be clearly outlined in the limited partnership agreement or the development services agreement at closing, and **the total amount of both paid and deferred developer fees may not exceed what is allowed by the state allocating agency.**

- **Paid Developer Fees** – Often referred to as paid, cash, or non-deferred developer fee, these funds represent cash that can be used to solve problems during the development process (e.g., if there is a cost overrun and the developer is unable to satisfy its construction completion guarantee, sources for the payment of developer fee can instead be used to cover the cost overrun). Accordingly, it is important to hold back as much of the paid developer fee as is possible within the context of the project. The larger the developer fee holdback until construction completion, stabilization /permanent financing conversion, and receipt of 8609s, the greater the cushion available to mitigate risk and increase the motivation for the developer to reach these important milestones.
- **Milestone Payments** – At project closing, typically no more than 25% of the developer fee is paid. However, underwriters may view this installment as a plug after having first calculated the necessary holdbacks related to the three other installments.
  - **Construction Completion** – Typically no less than 25% held back for subsequent installments (i.e., no more than a cumulative total of 75% paid with this installment). The amount held back until completion represents additional construction contingency and is sometimes expressed as a percentage of total hard construction costs. Some investors match the existing hard cost contingency with an equal amount of cash developer fee.
  - **Stabilization/Permanent Loan Conversion** – Typically no less than 10% held back for subsequent installments (i.e., no more than a cumulative total of 90% paid with this installment). Developer fee held back until permanent loan conversion represents funds available for permanent loan resizing and can be expressed as a percentage of the total permanent loan. As a general rule, 10% of the permanent loan is often held back until loan conversion.
  - **8609** – Developer fee amounts held back until 8609s are received provide resources for credit adjustors related to timing and basis changes. In addition, holdbacks until the developer supplies 8609s act as an incentive for all parties to remain focused on delivery of this document, which investors need to claim the tax credits. The amount of acceptable developer fee holdbacks varies depending on the credit worthiness of the developer to fund downward adjusters and the reliability of the projected lease up and credit delivery schedule.
- **Deferred Developer Fees – the deferred developer fee (DDF) should typically represent no more than 40% of the total developer fee.** These fees, or a portion of them, are often included in eligible basis for tax purposes. In general, to be included in basis the projections should demonstrate that the DDF could be paid from project cash flow within 10-15 years (consult a tax professional for details). Interest rates, if any, on DDF vary (consult a tax professional).

WARNING: In times of market stress it is not uncommon to see deals with DDF in excess of 40%, and investors may choose to accept slightly higher rates. When doing so, investors should be conscious of the erosion of the protection that robust cash development fees provide to mitigate development period (construction) and early operating period (market rent advantage, projected absorption, capture, and penetration rates) risks. Consider whether remaining cash development fee is a sufficient material incentive for developers, guarantors, and general partners to commit to solving problems that may arise.

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G. Credit Adjusters

Timing Adjuster – the amount of tax credits delivered to the investor can vary from original projections as a result of (1) a change in the month the project is placed in service or (2) the pace of lease-up. This typically occurs in the first two years of an investment, and any change in credits delivered during these years will be offset by a change in credits in years 11 and 12. **Timing changes do not affect total credits, but have an impact on their present value and the internal rate of return.**

- **Downward timing adjusters** are used to mitigate the negative impact of delayed credit delivery.
- **Upward timing adjusters** that offset early credit delivery, although not as common in today's market, are usually capped at 5-10% of total equity. Investors should be cautious about overly conservative leasing projections from a developer that could result in a sizable upward adjuster.
- **Timing adjusters are structured** in one of two ways:
  - **Predetermined Price** – Capital contributions are reduced or increased based on a specified price multiplied by the amount of credits delayed or delivered early. This predetermined price is usually set at a discount to the standard credit price.
  - **Yield Maintenance** – Capital contributions are reduced or increased based on maintenance of a predetermined yield. This calculation can include all tax benefits and timing of capital contributions or tax credits only. The latter eliminates any influence from additional losses generated by a delay and is preferable.

Basis Adjuster – the amount of total tax credits may vary based on actual qualified development costs set forth in the 8609. This causes a direct impact on total benefits to the investor.

- **Downward credit adjusters** minimize the negative impact of a reduction in total credits.
- **Upward credit adjusters compensate** a developer for additional credits delivered to the investor and are more common than upward timing adjusters in today's market; they are typically capped at 5-10% of total equity and computed at the credit price.

Typically, combined upward adjustors (timing and basis) will be capped at 5%-10%.

H. General Partner Representations, Warranties, and Covenants

It is typical for a limited partnership agreement to include "representations, warranties, and on-going covenants" from the general partner. These are designed as a mechanism to **ensure that there are consequences if the general partner fails to execute its key responsibilities, as well as to secure restrictions on the general partner's authority and require investor consents for certain actions.**

For example, the general partner may represent that the operating partner has "good and marketable" title to the project site. If this turns out to be incorrect, the limited partner can sue the general partner for damages.

Similarly, the general partner may represent that there are no pending material lawsuits against the general partner or any of its affiliates. If this turns out to be incorrect, the limited partner could sue the general partner for damages or possibly remove the general partner from the partnership.

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Covenants memorialize the ongoing obligations of the general partner. For example, the general partner may covenant that it will not cause the partnership to borrow any funds, not expressly permitted at closing, at any time during the compliance period without the limited partner's consent. If the general partner breaches this covenant, it may be liable to the limited partner for damages or may be removed from the partnership.

In some cases, the operating general partner may be a non-profit or other entity that was not active in the development of the project. In this situation, some or all of the representations and warranties may come from a developer-related entity that is not the general partner, because that entity may have greater knowledge of the facts.

It is important to make sure that a guarantor with financial strength guarantees the performance of the representations, warranties, and covenants.

I. Insurance

The investor's entire investment is at risk if property insurance is inadequate. General partners and sponsors need to annually have all-risk property and casualty coverage, as well as general liability coverage, reviewed and approved. Other insurance may be required based on an assessment of risks associated with environmental conditions including flood, earthquake, earth movement, hurricane, wind, etc. (See Due Diligence Section IV.E. Flood Zone Analysis for a discussion of flood insurance.)

J. Limited Partner Rights and Responsibilities

Under the limited partnership agreement, the general partner will have complete control of the operating entity, with the ability to make unfettered decisions subject only to express restrictions built into the agreement. The limited partner will only have those rights that are explicitly noted.

At a minimum, limited partners will typically want the following approval rights, which serve as restrictions on the right of the general partner to act unilaterally:

- Property management agent change
- Accountant change
- Significant operating budget changes
- Major reserve releases
- Employment of related parties (not previously disclosed)
- Amendments to the limited partnership agreement
- Any new loans, refinancing, or change in existing debt terms on the property, or on the general partner interests
- Any changes in general partner
- Any property disposition
- Substitute property investments
- IRS audit settlements

Among the key rights that limited partners should have are (1) the right to remove the general partner for material defaults in payment or performance or breaches of representations, warranties, and covenants, and (2) the right to transfer the interest in the operating entity to third parties. Depending on the context of the particular transaction, there may be many other significant rights that the limited partner should have. It is important to consult a lawyer experienced in LIHTC operating entity transactions.

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IV. DUE DILIGENCE

Due diligence covers a range of topics meant to provide investigative support regarding the risk of an investment. For each piece of due diligence analysis below, the impact, key points, and, as needed, important terms are highlighted.

A. Market Study

Market studies examine the local market to help predict the future performance of a project and can contradict conclusions drawn by other parties involved in a LIHTC property. Since data and conclusions become stale, a study dated beyond 6 months of age should be updated prior to closing to reflect current market conditions. A third-party firm not involved in the subject project should conduct the market study, and it should be commissioned by the syndicator rather than the developer to avoid potential biases inherent in developer-commissioned reports. Additionally, a market study should be prepared for all property investments (even in particularly strong markets) to assess the marketability of the proposed investment based on its relevant characteristics (size, tenancy type, unit types, location, etc.). The National Council of Housing Market Analysts (NCHMA) provides standards for types of information, analysis, and conclusions for a market study for an affordable housing project. (See NCHMA's Model Content Standards.) Market studies should include:

- **Impact** – Predicting the local demand and future operational performance of a project is critical to its future success for tenants, investors, and developers.
- **Key Points** – Studies typically include rents at comparable properties, estimates for achievable market rate and housing credit rents at the subject property, capture and penetration rates used to determine market acceptance, leasing expectations, area median income information, a summary of potential competitive additions to supply that are planned or under construction in the market area, and an evaluation of the physical characteristics of the project. The studies should also analyze other components of the project including commercial space, master leases, market rate units, and any other factors that could impact marketability and future operations. Market studies may also include operating expense comparables that can be used to verify underwriting assumptions.
- **Definitions**
  - **Capture Rate** – The percentage of age, size, and income-qualified renter households in the primary market area that the property must capture to fill the units. The capture rate is calculated by dividing the total number of units at the property by the total number of age, size, and income-qualified renter households in the primary market area.
  - **Penetration Rate** – The percentage of age and income-qualified renter households in the primary market area that include all existing and proposed properties (to be completed within six months) competitively priced to the subject that must be captured to achieve the stabilized level of occupancy.
  - **Achievable LIHTC Rents** – The maximum rents that the project could achieve as determined by the market study analyst.
  - **Achievable Market Rents** – The maximum market rents that the project could achieve without rent restrictions as determined by the market study analyst.

See NCHMA's *Dictionary of Market Study Terminology* for further information on market study terminology. The dictionary is included in the *Resources* section in the link noted above.

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B. Appraisal

Appraisal reports seek to estimate the market value of the project prior to completion and upon stabilization. For investors, substantiating acquisition costs is an important consideration for existing projects being rehabilitated using LIHTC. The acquisition price, net of land value, can often be included in the tax credit basis upon which the project receives 4% acquisition LIHTCs. Therefore, the appraisal should provide an "as-is" market land value (determined for restrictions and condition prior to the development) that supports the allocation of the property's purchase price between land and building costs. The appraisal should also support any seller "take-back" note for the overall acquisition price.

- **Impact** – Lenders use an appraisal as the basis on which to provide financing to a project. Appraisals can also provide investors with information on comparable properties, rents, and operating expenses and support for project acquisition costs.
- **Key Points** – Appraisals typically include comparable property sales information, net operating income estimates for the subject project, physical characteristics for the project, applicable rent limitations, and other items. Market values for the project typically are differentiated between pre-construction ("as-is" value), completion ("as improved" value), and a fully leased project ("stabilized" value). Market values are typically calculated based on (a) rents being restricted per LIHTC or other regulatory restrictions and (b) as if rents are not restricted.
- **Definitions**
  - **Income Capitalization (NOI) Approach** – Calculates the net operating income for the project and utilizes a capitalization rate derived from comparable sales to determine a market value for the subject property.
  - **Sales Comparison Approach** – Utilizes sales data of comparable properties to estimate a market value for the subject property.

C. Environmental Assessment

Environmental site assessments are used to identify environmental issues of concern, called Recognized Environmental Conditions (REC), prior to site acquisition and investor closing. If environmental issues are discovered, the **resolution should involve a "No Further Action" letter from the appropriate state agency regarding the issue.** Investigation may require assistance from investor's legal counsel and/or licensed environmental professionals.

- **Impact** – Identification of environmental issues prior to site acquisition allows for the development of remediation plans and projected cleanup budgets. Since environmental issues could affect the health of tenants, proper remediation is critical. Unmitigated, known environmental issues could result in legal liability to the project and general partner(s) and potentially involve investors. Generally, limited partners look to timely environmental reports either without or with mitigated RECs as a first step towards the innocent landowner defense. Investors should, in all cases, consult an environmental professional.
- **Key Points** – Environmental assessments should be performed no more than 6 months prior to site acquisition. Assessment types include:
  - **Phase I** – initial assessment typically including a review of records and limited site inspection and other procedures conforming to American Society for Testing and Materials (ASTM) standards.
  - **Phase II** – more detailed assessment generally performed in response to any REC found in a Phase I assessment. The Phase II assessment often includes sampling and laboratory analysis to confirm the presence of hazardous materials.

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- **Other** – noise studies (often required for HUD-financed projects), asbestos reports, lead-based paint reports, radon tests (recommendations regarding radon testing are typically included in Phase I environmental risk assessments based on location and soil conditions of the proposed development), etc.
- **Desktop Review** – a qualified professional should opine on the conclusions of the environmental assessments and make any additional recommendations.

WARNING: In multiple building projects it is often advisable to require radon testing on the first buildings delivered. This will allow mitigation strategies to be considered early, including design changes for subsequent buildings. Consult with environmental, architectural, and/or engineering professionals to determine what measures to include in preliminary scopes-of-work versus construction change orders. For example, vapor barriers and/or sub-slab vapor extraction piping might be recommended as part of an initial foundation budget, but active vapor extraction systems might be added later if post-completion testing indicates actionable radon levels. Consider the range of estimated contingent costs of these types of mitigation systems as potential change orders when evaluating the sufficiency of hard cost contingency reserves. Where Phase I environmental assessments for new construction recommend follow-up testing post-completion, consider requiring radon test results as a condition of payment of interim construction and/or completion installments.

D. Earthquake Risk Analysis

Properties in seismically active areas are at increased risk of damage and loss. To assess seismic risk, an evaluation is made by a licensed professional, generally a structural engineer, in a report typically known as a Probable Maximum Loss (PML) report or analysis. The report includes an estimate of the PML expressed in percentage terms of the total project value. **For a project with high seismic risk, project partners can choose an appropriate level of seismic insurance and/or modify construction plans** to incorporate additional seismic enhancements. Both would likely involve additional costs either in the form of upfront construction or ongoing insurance expenses.

- **Impact** – Understanding the likelihood of a seismic event and the potential impact on a project provides information needed to determine necessary construction mitigants, such as retrofits and/or design changes, and earthquake insurance requirements.
- **Key Points** – The PML or Seismic Reports share a number of common features:
  - **PML Estimate** – Lenders and investors historically required some form of earthquake insurance for a property with a PML above a certain percentage, generally around 20% or greater at a 90% confidence level. If required, insurance payments need to be included in project operating expenses. ASTM has introduced a Scenario Upper Loss (SUL) standard, which is defined as the loss to the building with a 90% confidence of non-exceedance and a Scenario Expected Loss (SEL) standard, which denotes the average expected loss to the building. In cases where the SEL is greater than 20%, the SUL is greater than 30%, or the property is less than one-half mile away from an Alquist-Priolo Special Earthquake Study Zone, investors may want to consider retaining discretion to terminate a proposed investment.

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- **Post Rehabilitation Estimates** – Projects may incorporate structural changes that could impact the PML estimate. As a result, investors should look for an "As Proposed PML," which incorporates all of the planned changes into the calculation.

E. Flood Zone Analysis

The Federal Emergency Management Agency (FEMA) is the federal agency tasked with producing Flood Zone information. FEMA uses an alphabetic code to denote the flood likelihood for a particular area based on historical data. **Properties in all flood zones beginning with an A or a V are required to purchase flood insurance to get a mortgage from a federally regulated financial institution or a Fannie Mae– or Freddie Mac–guaranteed loan.**

WARNING: Even if other parties do not require flood insurance, the investor may still desire that the project carry it. In particular, project partners may not be supportive of insuring developments in Zone D, which denotes unmapped areas. According to FEMA, "Although these areas are often undeveloped and sparsely populated when designated as Zone D, lenders may become aware that new development in such areas has increased the possibility of property damage from flooding. Consequently, they may require coverage as a condition of their loans, even though it is not federally required."

- **Impact** – Flooding can have significant physical impacts to a project, and property insurance typically does not include protection for flood-related losses.
- **Key Points** – Zone designations can typically be found on a property survey map.
  - **Insurance Costs** – Flood insurance is available from the National Flood Insurance Program. Because the insurance cost can be significant, it should be factored into the annual operating expenses of a project.
  - **Other Factors** – For developments located in areas where insurance is not required for a mortgage, investors may consider other factors in determining if flood insurance is desirable:
    - » **Base Flood Elevation (BSE)** – The site drawings should denote the BSE, as determined by the project engineer, which will indicate which portion(s) of the building(s) are potentially subject to flooding. In some cases, a building can be elevated above the BSE.
    - » **Letter of Map Amendment (LOMA)** – For unmapped areas (Flood Zone D), the general partner can submit an application to FEMA to amend the FEMA Map to map the area.
    - » **Letter of Map Revision Based on Fill (LOMR-F)** – The project engineer can determine that the building can be protected from flooding through site and building design. As a funding condition, the general partner can be required to submit a Letter of Map Revision Based on Fill (LOMR-F) from FEMA upon completion of the project. This indicates the site, as improved, is above the BSE upon completion of site work (e.g., fill, grading). Based on risk tolerance, each investor will determine the appropriate level of equity and fee holdbacks to mitigate the risk of receipt of a LOMR-F.

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F. Construction Review

Prior to project closing, a qualified third party should review the construction documents, parties involved, adequacy of the scope of work, relevant construction costs, and the construction schedule. The qualified third party typically is a firm or individual with construction experience or an individual internal to a syndicator (for investments involving a syndication firm). **The construction period is often the highest risk period of the project** and a pre-closing construction review can provide investors a realistic construction risk assessment, which can raise issues relating to the 9% 24-month rule, construction loan maturity deadlines, and/or credit delivery assumptions (i.e., lease up and related revenue timing).

- **Impact** – Pre-closing construction review provides an opportunity for early identification of construction-related issues such as budgetary concerns, reliability and experience of the construction team, and reliability of the construction schedule.
- **Key Points**
  - **General Contractor** – The GC should have experience with similar LIHTC projects. (For a discussion of GC due diligence, financial capacity and security, and the structuring of construction contracts, see Development Team Section I.D. General Contractor.)
  - **Capital Needs Assessment** – A Capital Needs Assessment (CNA) identifies the physical needs of an existing rehabilitation project. Known also as a Property Condition Report or Assessment (PCA) or Physical Needs Assessment (PNA), the report can be used to confirm that all physical needs of the project expected to arise over the 15-year compliance period are addressed by the rehabilitation.
    - **Percent of Units Inspected** – Ideally all units are inspected by a qualified professional, typically an architect.
    - **Scope of Work** – From the CNA, a detail of the rehabilitation work to be performed is translated into a scope of work. Investors should note any items called out in the CNA that are not being addressed as part of the scope of work.
    - **Replacement Reserves** – These are ongoing reserves funded by project operations annually. The ongoing capital needs of the project noted in the CNA should be considered when setting the level of annual funding of replacement reserves. Often transactions may have some replacement reserves funded through the capital budget, with the remainder funded through ongoing operations. (See Deal Structuring Analysis Section III.B. Reserves for guidelines on reserve levels.)
  - **Construction Timeline** – The timeline should be realistic, since changes have an impact on construction interest costs, completion dates, the start of unit leasing, and first year tax credit delivery.
  - **Zoning Requirements** – The zoning for a project can typically be found on the project American Land Title Association (ALTA) survey and a zoning letter from the city. The zoning should be confirmed with investor's legal counsel.
  - **Construction Costs**
    - **Construction Wages** – Some projects may be required to utilize Davis Bacon or state prevailing wages, which should be reflected in the construction budget. Triggers for these requirements include 8 or more project-based Section 8 units and 12 or more HOME-funded units.

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  - » **Construction Interest** – Budgeted construction interest should be based on a schedule that shows the likely draws from the construction loan.
- **Construction Contingencies** – Development budgets typically include additional funds for contingencies. While these figures vary based on the project complexity and partners, 5% of the construction contract for new construction projects and 10% of the construction contract for rehabilitation projects (with perhaps more for historic rehabilitation projects) are typical. Note that the percentage is based upon the total hard construction costs only. The contingencies should be "owner contingencies" controlled by the owner outside of the construction contract.

WARNING: If fewer than 100% of the units are inspected, underwriters should consider the implications of unforeseen construction issues on sufficiency of contingencies, guarantees, market advantage, reserves, and other mitigants that could potentially compensate for what ultimately might be an inadequate level of rehabilitation.

G. Construction Monitoring

After project closing, the construction process begins and a host of parties spring into action, including general contractors, sub-contractors, city entities, and various inspectors (e.g., local jurisdiction, HUD, if applicable, etc.). Construction monitoring refers to oversight of the construction process overall by an investor or representative.

- **Impact** – The project faces **heightened risk during this period as a result of the complexity of construction, the reliance on the coordination of multiple parties, and the potential for unknown conditions, particularly in the case of rehabilitation.** Delays in construction may have an impact on the timing of benefits, increase project costs, and, in the case of a 9% credit allocation, result in a loss of credits. (See Due Diligence Section IV.H. Tax Review for a discussion of placed in service deadlines.)

WARNING: Changes to the construction schedule and completion timeline can affect the project in many ways. Investors should pay particular attention to the impact of delays on the development budget, budgeted interest, cash developer fee, completion dates, lease up and credit delivery, permanent loan rate locks and commitments, and meeting the placed in service deadline. Upon experiencing a delay, investors should consult with the development team to ascertain all of the possible impacts and consequences.

- **Key Points** – Following are key areas of focus for investors during the construction period:
  - **Construction Monitors** – The investor or the syndicator representing the investor should engage independent third-party professionals to oversee the construction process. The construction monitor should attend construction meetings and review draw requests as appropriate to track project progress and costs, visiting the site no less than monthly. The construction monitor provides oversight of:
    - » **Construction Budget** – All uses of funds should be reviewed and tracked.

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  - » **Contingency Funds** – These protect against potential cost overruns and their use should be closely followed.
  - » **Construction Progress** – Monitors typically note a percentage complete for the project and should provide an estimate of the projected completion date based on the current construction progress.
- **Construction Equity at Risk** – Investors typically have a limited amount of equity at risk during construction (generally 10% to 20%), which serves to contain investor risk during this phase.
- **Additional Construction-Related Matters:**
  - » **Stored Materials** – Materials for the project that are yet to be used in construction must be physically on site or properly stored, secured, and insured.
  - » **Draw Downs** – Title insurance updates that ensure no liens exist against the property should be included with each construction draw request. Existence of liens could be a flag that there are construction issues.

H. Tax Review

The following LIHTC and broader tax law items are noted below as considerations only. Investors should work with tax counsel for guidance on these topics.

- **Placed In Service Deadlines** – Projects with a 9% tax credit allocation must be placed in service by 12/31 of the year following the credit allocation. Project partners can file a carryover allocation request with the tax credit allocating agency for an additional 12 months. Considerations include the following:
  - **Impact** – Failure of the project to meet the placed in service deadline results in a complete loss of all credits for the investor.
  - **Key Points** – Particular focus should be paid to the construction progress:
    - » **Construction Schedule** – The construction schedule should provide an adequate cushion between the projected completion date and the placed in service deadline. Note also that projects in colder climates can experience additional construction delays due to weather.
    - » **Construction Sources** – In the event of delays, construction can often be expedited, but this generally comes at an additional cost. As a result, monitoring of potential sources to cover these overages, mainly contingencies and developer fee holdbacks, becomes particularly important.
    - » **Enhanced Construction Monitoring** – Projects with tight schedules might require additional construction monitoring, including added oversight and site visits.
    - » **Other factors to consider** – For projects with tight schedules, the equity contribution schedule should be structured more conservatively to mitigate construction risk. The experience of the developer and general contractor and the building delivery schedule should also be considered when evaluating this risk.
- **10% Test** – The amount of **costs expended within one year of the date the project received its tax credit allocation must be at least 10% of the reasonably expected basis at completion.** Typically this test can be met through the partnership's acquisition of the land and/or building at construction loan closing, but meeting the threshold depends on the acquisition expenditures in relation to the overall total development costs and eligible basis. Failure to meet this 10% test may result in the loss of the allocation. Satisfaction of the 10% requirement should be evidenced by an independent auditor's report.

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- **4% Tax Credit Projects Rate** – Projects receive their credits based on a percentage of qualified basis multiplied by a floating rate. Projects with a 9% credit allocation utilize a rate that is fixed under current law at 9% for costs other than basis eligible acquisition costs and a floating 4% rate for basis eligible acquisition costs (for rehabilitation projects). Projects with a 4% allocation, either new construction or rehabilitation, have a floating 4% rate applied to their basis eligible costs related to both acquisition and construction. The 4% rate can be locked via written election at LIHTC reservation or can float until the project is placed in service, at which time the rate published by the IRS for that month applies. For a 4% bond-financed project, both the rehabilitation and acquisition rate can be locked via a written election in the month of the bond issuance or within 5 days of the following month. **Investors should focus on when the developer plans to lock the tax credit rate and determine the downside risk to the projected tax credits, along with the adequacy of the cash development fee holdback to fund a potential downward adjuster.** Should the rate fall, the project will produce fewer tax credits, all else being equal.

- **10-Year Rule** – There must be at least 10 years between the last time a building was placed in service and the acquisition of the project for a new LIHTC execution. This rule only applies to the acquisition portion of the transaction. Proposed rehabilitation costs are considered a "new building" for tax purposes. Exceptions to the 10-Year Rule apply to buildings already receiving HUD or other State operating subsidies. **Investors should discuss with counsel any instance in which a syndicator or developer proposes a transaction prior to the completion of 10 years since the building's last placed in service date.**

- **Anti-Churning** – Under tax law, no building can be placed in service twice by the same owner. Therefore, **the seller and buyer of a building must be unrelated for tax purposes.** The intent is to prevent owners from continually resetting depreciation to extend depreciation tax benefits. For a LIHTC transaction specifically, the additional intent is to prevent the utilization of acquisition credits twice by the same building owner. This rule does not apply to the rehabilitation costs, as such costs are considered a new building for tax and depreciation purposes. Parties are considered related if the buyer and seller have 50% or more common ownership as determined by a profits (percentage of cash flow or other benefits; 90% cash to general partner and 10% to limited partner) or capital (percentage of ownership: e.g., 99% limited partner and 1% general partner) interest. Therefore, for a LIHTC partnership, this would involve all parties to the partnership (investor, syndicator, general partner) on a combined basis and for both past and present transactions. Note that this would include investors in a current or prior multi-investor LIHTC fund as well. Violation of the related party rules would put the acquisition tax credits and depreciation for the project at risk. **Investors should ensure that they have never previously invested in the subject building through previous multi-investor or other LIHTC funds.**

- **50% Test** – This test applies to projects receiving 4% tax credit allocations that are financed by tax-exempt bonds. For these projects, **more than 50% of the project's aggregate building and land tax basis (not *LIHTC eligible* basis) must be financed by the tax-exempt bonds to ensure 100% of LIHTC eligible basis will be recognized for the determination of the 4% credits.** Failing this test results in a significant loss of credits and will likely result in a repurchase event, because any amount funded below 50% reduces eligible basis to that lower funded percentage. For example, a funding of 49% of the building and land tax basis will result in credits calculated based on 49% (rather than 100%) of eligible basis. In consultation with tax counsel, investors should consider requiring that lower tier partnership agreements include a provision requiring the developer to reduce its fee to the extent necessary to meet this test and should include failure to meet the 50% test as a repurchase event.

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- **Substantial User Rule** – This federal rule restricts the ability of a single entity to benefit from federally tax-exempt debt as both a borrower (who pays a lower tax exempt rate) and bond owner (who receives tax exempt interest). Therefore, **in a tax exempt 4% LIHTC transaction, the LIHTC partnership and bondholder must be unrelated for tax purposes (less than 50% common ownership).** Should this issue arise, investors should consult their tax professionals to structure the transaction. Typically, either the related investor will own less than 50% of the partnership prior to pay down of the bonds, or the bondholder agrees to pay taxes on the bond interest (and accordingly charges the partnership an interest rate seen on taxable bonds in the market).
- **Program Investment Rule** – This federal rule **requires the borrower and bond owners to be unrelated when the issuer of the bonds is receiving greater than 0.125% ("1/8 Rule") yield** on its bond issuance. Unlike the Substantial User Rule, this rule cannot be addressed by the bond holder paying taxes on the bond interest. Investors should consult tax/bond counsel should this issue arise. Typically an investor will have to ask the issuer to confirm their expected yield, as this issue will not be addressed in the tax opinion and may not be addressed in the bond opinion.
- **Developer Fees** – Some portion of the developer fee may be paid from development sources and some portion may be deferred and paid over time from the proceeds of project operations. Some key items to note include the following:
  - **Developer Fee Size** – In addition to complying with the state housing agency requirements, the developer fee should also represent less than 15% of other eligible costs (excluding the development fee itself) to reduce the risk of IRS scrutiny during the course of an audit.
  - **Deferred Developer Fees** – This is the portion of the developer fee not paid from development sources. For this portion of the developer fee to be included into qualified eligible basis and generate tax credits, **the deferred fee must be expected to be repaid at some point during the compliance period.** The industry standard is to ensure any deferred developer fee note is a high priority of the cash flow waterfall. In addition, typical language in a limited partnership agreement (LPA) will require the partnership to repay any outstanding deferred developer fee note prior to Year 15 (using funds from the guarantor provided to the partnership via the general partner). **However, tax counsels may differ on the view of whether such fee must actually be paid down in later years, if the initial projections at closing showed a reasonable expectation that the fee would be paid down from operations.** An investor should discuss with tax counsel any case where a significant amount of fee is deferred and the projections rely on the deferred developer fee note in eligible basis to generate LIHTC and/or for minimum gain purposes. (See Due Diligence Section IV.H. Tax Review under Capital Accounts for a discussion of minimum gain.)

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- **Allocation of the Developer Fee between Acquisition and Rehabilitation Basis** – Since acquisition expenditures generate fewer credits (4% tax credit rate) than rehabilitation expenditures, which benefit from either a 4% or a 9% tax credit rate and/or receive a 30% basis boost, the allocation of the fee between the two should be evaluated for reasonableness. In the event of an audit, the IRS could reallocate a portion of the fee to acquisition basis or land, resulting in a reduction in tax credits.
- **Inclusion in 10% Test** – For purposes of the 10% test, the amount of the development fee includible should generally be limited to the ratio of development services completed compared to the entire suite of development services expected to be provided. Investors should consult their tax professional for guidance.
- **Related Party Contractors** – Consider whether general contractor fees, profit, and/or overhead costs could be recharacterized as developer fees or included under caps by the IRS or housing credit agencies.

- **Capital Accounts** – Capital accounts represent the equity each partner has in the partnership. They are increased primarily by capital contributions and on occasion by ongoing taxable income for projects with high levels of cash flow, and they are decreased primarily by allocations of operating losses, namely depreciation. Important considerations include the following:
  - **Loss Allocations** – Due to tax law requirements relating to a concept referred to as "substantial economic effect," **tax credits must follow a key economic benefit in the partnership, namely losses.** If losses are allocated away from the limited partner during the credit delivery period, the limited partner will lose the credits.
  - **Minimum Gain** – Investors can claim operating losses, and thus credits, to the extent their capital account balance is positive, meaning the losses taken do not exceed the partnership's capital contributions in the transaction. However, a partnership can continue to take losses beyond its equity to the extent there is the appearance of "minimum gain," which applies when the outstanding non-recourse debt on the property exceeds the partnership's adjusted tax basis. In such a case, losses are deemed to be funded by non-recourse debt secured by the partnership. However, in any case where the projections show minimum gain, tax counsel should review the specific debt structure against "stacking rules" that may require the reallocation of losses away from the limited partner investor and toward the general partner, who is deemed to be at-risk for such debt. Such reallocation during the 10-year credit period would result in a loss of credits to the limited partner investor.
  - **Deficit Restoration Obligations** – As a result of changes to bonus depreciation in the 2017 Tax Cuts and Jobs Act, and in the context of market conditions where delayed equity pay-ins are prevalent, there are increasingly instances of LIHTC partnerships experiencing projected temporary negative capital accounts in initial years (typically years 1-5, when most lower-tier equity is contributed). Some practitioners propose deficit restoration obligations (DROs) that obligate a partner to "restore" a negative capital account upon dissolution by making a special capital contribution. Less frequently, DROs may be proposed when stacking issues occur later in a transaction (e.g., in year 9, after all capital has been contributed, losses have driven tax capital accounts negative, minimum gain allocations are insufficient to permit further allocations of depreciation/losses, and there remain projected tax credits to be allocated). As a tax matter, the existence of a properly structured DRO allows a partner to continue to be allocated depreciable losses (which, in turn, allow the continued allocation of tax credits) beyond what would otherwise be permitted by IRS rules.

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WARNING: DROs constitute a potential contingent funding obligation beyond ordinary capital contributions. While they affect direct and multi-fund investments in different ways, DROs have the potential to (1) obligate an investor to make payments in excess of ordinary capital calls and adjusters and/or (2) limit otherwise distributable cash proceeds. Explicit syndicator disclosure to investors of the existence of any DROs as well as the facts, terms, and tax projections relating to the circumstances leading to their negotiation, structuring, and inclusion in any lower-tier agreements is recommended. Use of a DRO should be discussed with the investor's tax advisor.

- **Legal Opinions** – Investors typically seek legal opinions covering a number of key items; requirements vary by investor and investment type but include the following:
  - **Project Level Tax Opinions** – These opine on tax-related items to the project structure to ensure that projected benefits will likely be received by investors from a tax perspective.
  - **Fund Level Tax Opinions** – These typically opine on a number of items for tax purposes including (a) classification of the partnership as a partnership, (b) investors being treated as partners, (c) allocations of income, gain, and loss being respected, and (d) the assurance that the tax credits can be claimed by investors.
  - **Equity or Admission Opinions** – Commonly found in both multi-and single-investor funds, these provide support for the organization of all parties, the fund partner, and the fund.
  - **Bond Opinions** – Tax-exempt bonds need to be structured to meet IRS guidelines and the bond opinion (sometimes loosely referred to as a "95-5" opinion in New York City) is prepared on behalf of the bond issuer. It likely will not address substantial user and other investor-specific issues. It may also not address specific structural issues that could impact the 50% test determination, which is typically considered a tax opinion, not a bond opinion, issue. Therefore, an investor will need to address such issues directly with its tax counsel as needed.
- **Exclusions from Qualified Eligible Basis** – Qualified eligible basis refers to the costs to construct the building that are used in calculating the amount of credits ultimately allocated to an investor. Not all project costs are eligible for inclusion and improper classification could impact investor benefits. For example, the costs must be associated with the construction of the residential component of the building. **Some typical cost items excluded from basis include commercial space construction costs, reserves, permanent financing costs, and other non-depreciable costs. Land acquisition and depreciable land (site) improvements that accrue to the land's tax basis are also excluded.**
- **15-Year Tax Credits** – For each building identification number (BIN) within a LIHTC project, units leased prior to 12/31 of the first tax credit year will deliver tax credits over a 10-year period. **Units leased after 12/31 of the first tax credit year deliver tax credits over an extended, 15-year period with fewer tax credits delivered each year.** Note that project projections and investor yield are typically calculated assuming a 10-year credit delivery period, and the longer 15-year credit delivery period will reduce investor yields. As a result, investors should pay particular focus to the timing of lease up that is near the end of the year and the utilization of multiple BINs within a single building to reduce the chance of 15-year credit delivery and maximize credits.

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- **Interest Expense Deductions** – Under the changes imposed by the 2017 Tax Cuts and Jobs Act, interest expense deductions are limited to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA), or earnings before interest and taxes (EBIT) after 2020, unless the partnership elects to be treated as a real property trade or business (RPTOB). Interest deductions generate taxable losses and therefore have an impact on the investor's yield. With a limitation imposed on interest deductions, total deductions remain the same, but the timing of the deductions will change (i.e., fewer taxable losses received over the compliance period and a larger capital loss at the end of the investment period to zero out the capital account). When the RPTOB election is made for residential rental property (to allow for full interest expense deductions), real property placed in service on or after January 1, 2018 must be depreciated over a 30-year recovery period under the Alternative Depreciation System (ADS). The election can be made at any point during the investment period, so it is important for underwriters to evaluate the facts and circumstances of each investment to determine the most advantageous time to make the election.

I. Other Underwriting Considerations

1. Parking

Local zoning typically requires a certain number of parking spaces per unit. For underwriting purposes, investors should consider at least one off-street parking space per unit as a minimum threshold and adjust according to the local density (urban/rural) and tenancy (senior, supportive housing, family, etc.). For example, in certain urban areas off-street parking may not be required by zoning (e.g., a transit-oriented development area) nor may it be a demand of potential tenants.

WARNING: In instances where parking ratios of less than 1 space per unit (1:1) are proposed, look for precedent in the market study, appraisal, or comparable projects in the primary market area.

2. Project Amenities

Generally the market study will identify amenities common at other competing properties and note any missing for the subject property. Note that a lack of amenities when compared to competing projects could impact achievable rents. (See Deal Structuring Analysis Section III.A.1. Revenue Analysis.)

3. Shared-Use Agreements

LIHTC projects can be sourced and built in phases with separate tax credit allocations, partnerships, and partners for each phase. These phases are typically planned together in advance, but built in different periods of time (e.g., building one may be built and fully leased before construction on building two begins). The two phases may share common space and operating costs, which would be detailed in a shared-use agreement between the two partnerships that includes the following:

- **Shared Space and Costs** – The agreement should clearly denote the physical space being shared between the projects, as well as the costs being allocated to each. In cases where costs are shared with market rate projects, caps should be negotiated to protect the tax credit project from luxury upgrades that the market rate tenants may want in the future, which could affect the affordable project's feasibility.
- **Payment Defaults** – The agreement should detail the procedure and rights of parties when a payment default occurs. **Investors should ascertain the ability of their project to operate without the shared space as well.**

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WARNING: Given the interrelationship among shared amenities and shared costs of related phases, consider the ability of the phase being underwritten to survive in the event of failure of the other phase(s). Specifically, consider whether future financing, recapitalization, sale, or stable operations will be feasible as a stand-alone phase with only the explicit contractual rights granted by the existing cross-use agreement.

4. Supportive Housing

Supportive housing within a LIHTC project typically refers to units reserved for tenants with unique needs. These can include residents with mental health illnesses, formerly homeless tenants, or other designations noted by the state allocating agency. Supportive housing also typically includes social services focused on the needs of particular tenants; these services are often required as part of the tax credit allocation and/or other financing.

Supportive housing may involve additional costs to the development and complicate the marketability of the project for non-supportive units. Additionally, the costs of social services can have an impact on project operations over time. It is important for the investor to understand the requirements around tenancy and services for supportive housing developments. (See AHIC's Operating Subsidy Underwriting Guidelines for further discussions.)

- **Set Aside** – The tax credit allocating agency and/or project lenders can require the project provide units for a specific tenant group, typically denoted as a "set aside." Set asides may remain in place for the entire credit period. Some set asides may be on a "best efforts" basis where failure does not impact the project, while others may be hard requirements. Investors should determine the implications of not achieving the set aside and, at a minimum, should **seek language that allows release from the set aside in the event that the project encounters financial difficulties,** including loss of operating subsidies and/or off-budget social service funding. (See AHIC's Operating Subsidy Loss Regulatory Relief Language.)
- **Impact of Restrictions** – Set asides may remain in place for the 15-year compliance period or longer. Often, restricting the tenant base may impact the ability of the project to increase rents in periods of financial difficulty. For example, a set aside for formerly homeless tenants could result in a tenant base with limited ability to pay higher rents. Set aside tenants could also bring rent subsidies to the project; this is generally a positive factor but does bring some underwriting nuances.
- **Social Services** – Set asides may also require social services be provided to tenants such as literacy education, financial guidance, employment assistance, etc. These services can be critical to the success of tenants and are a vital component tied to the housing. More importantly, many set asides (particularly in New York City, California, and several other states) are for tenants with mental and/or physical disabilities who will need more intensive services, including daily case management, to successfully live independently.

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- **Service Provider** – Services should be provided by an organization experienced in working with the target tenant population. Investors should note the terms of the contract and investigate other potential service providers in the local area that might be able to substitute for the primary provider. The property manager should also have previous experience with the tenancy and preferably with the service provider.
- **Source of Funding** – Social services can be funded from project operations, through ongoing subsidies, by a capitalized project reserve and/or other means.
  - **Project Operations Funding** – Investors should confirm that the underwriting includes the cost of social services in the projections and that the project operates well, in terms of debt coverage and cash flow, with these costs included in the budget.
  - **Ongoing Subsidies Funding** – Investors should note the term of the subsidy contract, likelihood of any funding reductions or eliminations, and the impact on project operations of any reduced subsidy funding.
  - **Reserve Funding** – Investors should determine the ability of the reserve to fund social service costs over the 15-year compliance period.

WARNING: Uncommitted funding sources fund a portion of ongoing project costs without providing a long-term commitment. Ideally, the project can fund these project costs from ongoing operations in the event that the funding source is discontinued. If that is not the case, investors should understand the ultimate source of funding and likely longevity to determine the possible impact to the project.

V. SYNDICATOR REVIEW

Syndicators provide investors with opportunities to invest individually through proprietary funds, or collectively through multi-investor funds. Generally, their role includes acquisition, underwriting, and closing of individual LIHTC projects; offering and closing of investors into a syndicated fund; and asset managing the projects and overall fund for the life of the fund. Given their role, their capabilities, historical performance, and longevity are key to their ability to manage the investments initially and over time. Realizing the importance of their role, AHIC has developed a number of tools to analyze syndicator partners as noted in the links below:

- **Guidelines** – AHIC's Syndicator Review Guidelines provide a discussion of key factors to consider related to syndicator partners.
- **Templates** – The following templates are information requests to be completed by the syndicator directly and used by the investor to better ascertain longevity, performance, ability, and risks related to the syndicator partner.
  - Staffing Template
  - Business Concentration Template
  - Sustainability Template
  - Fund Performance Template

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AHIC | AFFORDABLE HOUSING INVESTORS COUNCIL

About AHIC

The Affordable Housing Investors Council (AHIC) is a non-profit association whose members support the development of affordable housing by investing in the federal low-income housing tax credit. We provide educational opportunities, create a forum for members to share their insights on issues facing the field, and promote the investor's perspective in this unique public/private partnership. Through these activities, as well as the creation of industry best practices, we seek to preserve and strengthen the credit as an efficient and effective tool for the development of affordable housing.

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