



# Project Financing Techniques and Options

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Basic Project Financing

Advanced Project Financing



# Basic Project Financing Techniques

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# Available Project Financing Mechanisms

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- Pre-development financing
- Construction financing
- Permanent financing
- Rent and operating subsidies



# Pre-Development Financing

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Grants and low-cost loans frequently fund early, high-risk expenses such as option fees or site engineering - particularly for nonprofit sponsors that do not have their own pools of venture capital.



# Construction Financing

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- Low-cost construction loans can reduce interest costs by hundreds or thousands of dollars per unit.
- In syndicated rental projects, typically one-third of the equity is advanced for construction, further reducing interest carry costs.
- Grant financing is less common - used mainly for construction of public housing, housing for the elderly and homeless or home repairs for the poor.



# Permanent Financing

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- All of the financing mechanisms can come into play, except for rent subsidies and operating subsidies, which have only indirect effects on permanent financing.
- Non-conventional permanent financing generally has the effect of reducing or, more rarely, totally eliminating debt service on the project.
- Grants for down payment assistance and closing costs have a different purpose - helping cash-poor home buyers qualify for conventional financing.



# Rent Subsidies

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- **Tenant-based assistance**, by which the subsidies "float" with the tenant, who is free to move at the end of each one-year lease period.
- **Project-based assistance**, which are intentionally "attached" to specific affordable housing projects for periods of 10 to 20 years. The subsidy is used to increase the amount of financing that otherwise could be raised for a rental project.



# Operating Subsidies

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- Operating subsidies for public housing are one of the major federal expenditures on affordable housing, but are not limited to public housing.
- HUD's Flexible Subsidy program provides about operating subsidies to older, privately owned rental properties financed with federal money.
- Occasionally, governmental housing finance agencies or private foundations offer very limited operating subsidies to affordable housing development projects - usually only to see them through the rent-up stage.





# Project Financing Mechanisms

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- Market-rate loans
- Below-market-rate loans
- Project-based loans
- Deferred payment loans
- Owner equity and equity syndication proceeds
- Lease purchase loans



# Market - Rate Loans

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- Market-rate loans are offered by banks, thrift institutions and mortgage companies to homebuyers and investors in rental property.
- Insurance companies and public pension funds also make direct real estate loans, but rarely with affordable housing projects, because the transactions are typically too small to be profitable.
- There is no set "market rate" of interest for housing loans - rather, a range of rates which are found in the market.
- These rates are primarily functions of three variables: (1) the perceived risk of the investment, (2) the costs of doing the transaction and (3) supply/demand factors.



# Below-Market-Rate Loans

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- A below-market-rate loan can be defined as any loan with an interest rate that is clearly lower than prevailing market rates, taking into account the market factors just described and the particular benefits and risks of the transaction in question.
- Common sources:
  - Direct low-interest loans from government agencies
  - Lending using federal sources
  - The proceeds of selling tax-exempt bonds
  - Credit-enhanced investments
  - Housing finance agency reserves
  - Community Reinvestment Act (CRA) motivated
  - An investment pool that mixes market-rate funds with
  - Other innovative sources of capital



# Project-Based Grants

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- Project-based grants are used for the acquisition, construction or renovation of affordable housing.
- These are distinguished from other types of grants that might, for example, be used to pay rent subsidies, capitalize a loan pool or underwrite the operating expenses of a nonprofit housing organization.



# Uses of Project-Based Grants

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- A HUD grant to a nonprofit organization to build a homeless shelter, "Section 202" apartments for the elderly, "Section 811" housing for the disabled.
- Grants to low-income families to renovate their homes - typically made by local governments using the HUD HOME program or CDBG programs
- Weatherization grants to low-income families or their landlords - using funds from the Department of Energy and other sources
- Grants to low-income home buyers for down payment assistance - often made with funds from HUD's HOME program, the Community Development Block Grant Program or local housing trust funds.



# Deferred Payment Loans

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- In the affordable housing industry, "deferred payment second mortgage loan" typically means that **all** payments of principal and interest are deferred until resale of the property or conversion to another use.
- Such loans are also called "soft seconds".
- They typically generate no return on investment, are not amortized (repaid monthly) and are made with non-conventional sources of investment capital.



# Owner Equity and Equity Syndication Proceeds

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- Owner equity can be defined as cash or something else of value provided by the owner to a real estate transaction that involves acquisition, construction or refinancing.
- For example, a homebuyer's down payment is equity.
- An investor's cash paid into a deal is equity.
- The market value of land or buildings provided to a deal is equity.
- With rehabilitation of a property for an existing owner, the owner's equity is usually valued as the difference between the market value of the property and debt on the property.



# Lease-Purchase Loans

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- In a typical program, a local government agency or nonprofit group arranges financing for a group of homes - whether homes to be built, rehabbed or simply bought in the open market.
- The program sponsor sells the homes to low-income families who do not currently qualify for conventional financing - usually by failing to meet down payment requirements.
- A slight surcharge on the monthly payment builds up a reserve account for the down payment.
- The loan to the program sponsor is essentially a multifamily housing loan that converts to a single-family home purchase loan in a year or two, when the lessee buys the home.





# Inducements to Project Financing

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- Loan guarantees
- Mortgage insurance
- Interest subsidies
- Mortgage purchase programs (secondary markets)
- Compensating balances
- Linked deposits
- Matched funding
- Non-conventional underwriting
- Tax credits
- Tax-exempt lending provisions
- Mortgage credit certificates



# Loan Guarantees

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- A loan guarantee is a promise by a person or entity to make good on a loan if it goes into default.
- The guarantor may be the borrower, but more commonly is a government agency.
- In occasional profit-motivated deals, individually-tailored loan guarantees are provided for a price.
- For example, a lender may want a construction loan guaranteed, but the borrower does not have enough liquid assets to make good on the guarantee.
- Some local governments and charitable foundations have provided loan guarantees for nonprofit housing developers (most of which have both low net worth and few liquid assets).



# Mortgage Insurance

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- From the lender's point of view, mortgage insurance is very similar to a loan guarantee.
- With mortgage insurance, a private or public agency agrees to make good on a loan if it defaults.
- But these are several differences from loan guarantees:
  - (1) mortgage insurance is almost never individually tailored (as a guarantee may be),
  - (2) the risks to the guarantor are more limited, and
  - (3) it is a money-making business.



# MORTGAGE PURCHASE PROGRAMS (SECONDARY MARKETS)

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- Many lenders make a loan and immediately sell it to a national mortgage institution such as Fannie Mae or Freddie Mac.
- The originator may still collect monthly payments (called **servicing** the loan) under contract to the new owner of the mortgage.
- Fannie May will buy home purchase loans that were piggybacked with a deferred payment mortgage, so long as homebuyer training was provided.



# INTEREST SUBSIDIES

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- While a below-market-rate loan is one with an inherently low rate of interest, an interest subsidy is a payment of cash to a lender in exchange for a lower interest rate.
- These subsidies are sometimes called "write-downs" or "buy-downs" of the loan.
- In the affordable housing industry, an interest subsidy typically involves a third party - usually a government agency - making a one-time payment to a conventional lender in order to reduce monthly loan payments for a low-income home owner, a nonprofit housing developer or (rarely) a profit-motivated developer.



# COMPENSATING BALANCES

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- Occasionally, loan interest rates are subsidized by a method other than a cash payment made in exchange for the reduced income.
- Instead, government agency or socially-motivated investor deposits funds with the lender at no interest or a low interest rate.
- The terms of the deposit are designed to compensate for the lender's loss of interest income from making a low-interest loan.



# LINKED DEPOSITS

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- Because the nature and magnitude of their portfolios, major institutions have been used creatively to induce lending for affordable housing projects.
- The portfolios are typically a mix of short-term, middle-term and long-term investments.
- In most cases, the long-term investments are conservative ones with yields similar to 30-year treasury notes.
- Some pension funds have made agreements with public and private lenders to create linked deposit programs with community development objectives.



# MATCHED FUNDING

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- The nation's best-known and largest matched funding program used to finance affordable housing is the Federal Home Loan Bank's Community Investment Program (CIP).
- You approach a lending institution that is a member of the Home Loan Bank, which entitles it to use the CIP program.
- Under CIP, the Home Loan Bank borrows money in the major capital markets at relatively low rates.
- The lending institution would normally make a loan for about two points over its cost of money, the rate at which the project is feasible.





# NON-CONVENTIONAL UNDERWRITING

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- Liberalized underwriting allows a lender to make a loan to an applicant who would not otherwise be qualified.
- The most common motive is a desire to comply with the Community Reinvestment Act (CRA).
- Non-conventional underwriting can vary from conventional underwriting one or more of these ways:
  1. Loan-to-value ratios are liberalized.
  2. Down payment requirements are reduced.
  3. "Debt ratios" applied to borrowers' incomes are liberalized.
  4. Credit reports showing more payment problems are accepted.
  5. More irregular employment histories are accepted.
  6. Alternate forms of income (like food stamps) are accepted.
  7. Liquidity standards for borrowers (conventionally, cash in the bank for two months' mortgage payments) are lowered.



# TAX CREDITS

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- As a result of certain provisions in the federal tax code, **tax credits** are available for investors in low-income rental properties.
- These tax credits greatly increase the return on equity for certain investors, so much so in some instances that cash returns on the investment are of little or no importance.
- The two relevant federal tax credits are:
  - The Low-Income Housing Tax Credit program, which allows the project owner tax credits of 40 to 90 percent of the value of a residential rental property over ten years if the owner agrees to keep rents and tenant incomes below certain levels.
  - A 20 percent tax credit for rehabilitating a certified historic structure.



# TAX-EXEMPT LENDING

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- Internal Revenue Code allows the interest from many types of investments to be exempt from federal taxes - if defined public purposes are being served by the investment.
- In the affordable housing industry, most tax-exempt lending is accomplished through issuance of tax-exempt bonds.
- There are two major types of tax-exempt bonds:
  - (1) revenue bonds and
  - (2) general obligation bonds.



# MORTGAGE CREDIT CERTIFICATES

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- Federal rules allow a fairly simple alternative to the expensive and complex business of issuing and selling bonds to raise tax-exempt investments for housing loans.
- The device is called a **mortgage credit certificate**, which simply gives the borrower a federal income tax credit for a portion of the interest on a qualified mortgage.
- In underwriting a loan with a mortgage credit certificate, a conventional lender calculates a monthly pro-ratio of this tax credit.
- This amount is added to the borrower's maximum spending capacity for PITI (principal, interest, taxes and insurance).
- This, in term, qualifies the borrower for a bigger loan, just as if the interest rate on the mortgage were a percentage point or so lower.



# Uses of Public Intervention Money

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- Reduce the costs and/or cash required
- Increase income
- Reduce expenses
- Reduce the financing costs
- Improve the economic and investment environment
- Improve the informational environment



# Real Estate Development Risks & Risk Mitigation

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- Predevelopment loan risks
  - project infeasibility
  - insufficient collateral
- Acquisition loan risks
  - insufficient/unavailable permanent financing
  - insufficient project income
- Permanent financing risks
  - insufficient net operating income
  - inadequate loan to value ratios
  - poor credit



# More on Development Risks

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- Borrower risks
  - developer track record
  - current development capacity
  - fiscal/management status of the borrower
- Project risks
  - failure to complete the project
    - physical problems
    - cost overruns
    - poor general contractor performance
    - financial failure
  - failure to repay the loan
    - developer mismanagement
    - market failure
    - inexperienced property management
    - failure of renter incomes to track growth of expenses



# Mitigation Risks in Real Estate The Predevelopment Loan

LOAN TYPE	RISKS	RISK MITIGATION
Predevelopment Loan	<p><u>Non-Repayment:</u> resulting from the project not going forward because studies determined project was not feasible</p> <p><u>Non-Repayment:</u> Due to value of collateral used to secure the note being insufficient to cover the amount of the loan.</p>	<p>a) Provide lender with alternative source of repayment.</p> <p>b) Make sure that to collateralize the loan, and provide alternative source of repayment.</p>



# Mitigation Risks in Real Estate

## The Permanent Loan

LOAN TYPE	RISKS	RISK MITIGATION
Permanent Financing	<p><u>Non-Repayment:</u> Buyers with incomes insufficient to obtain permanent financing.</p> <p><u>Non-Repayment:</u> Project NOI insufficient to make debt service payments</p> <p><u>Non-Repayment:</u> Project experiences high vacancy rate due to poor management.</p> <p><u>Non-Repayment:</u> Loan amount needed exceeds the loan to value ratios of the lender.</p> <p><u>Non-Repayment:</u> Poor credit</p>	<p>a) Have market data that proves market demand from buyers with specific incomes to obtain a mortgage loan sufficient to purchase the house</p> <p>b) Have market data that shows potential rental demand from renters with incomes high enough to pay rents that generate NOI sufficient to pay debt service.</p> <p>c) Employ good management company that will operate the project efficiently and keep operating costs under control and maintain the curb appeal of the project</p> <p>d) Raise equity or soft subordinate financing to reduce the amount of permanent financing needed</p>



# Mitigation Risks in Real Estate

## The Acquisition Loan

LOAN TYPE	RISKS	RISK MITIGATION
Acquisition Loan	<p><b><u>Non-Repayment:</u></b> Due to project not going forward because remainder of financing could not be obtained.</p> <p><b><u>Non-Repayment:</u></b> Due to project income being insufficient to cover debt service in an amount that will repay acquisition loan, thus converting acquisition loan to equity</p>	<p>a) Have an alternative form of repayment.</p> <p>b) Development multiple methods of financing your project.</p> <p>c) Do not agree to subordinate the acquisition loan to other financing.</p> <p>d) Have market data that shows you there are buyers or renters with incomes high enough to afford rents or sale prices sufficient to repay debt service in an amount to repay loans and cover development costs.</p>

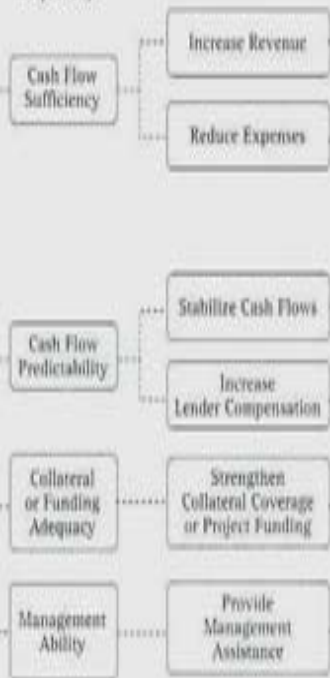
## Project Analysis

Lender Analysis  
Project Development  
Issues



Gap Analysis  
Project Gap

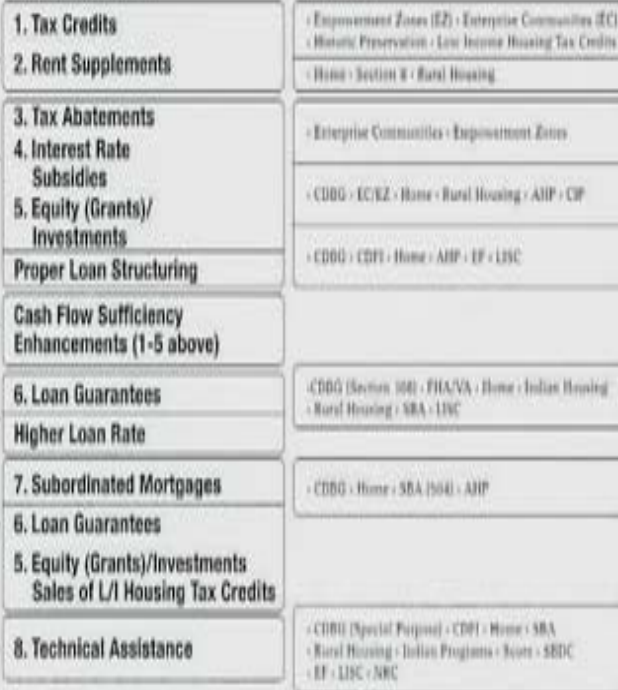
Gap Resolution Strategies



## Enhancement Analysis

Enhancement Types

Examples



## Project Redefinition

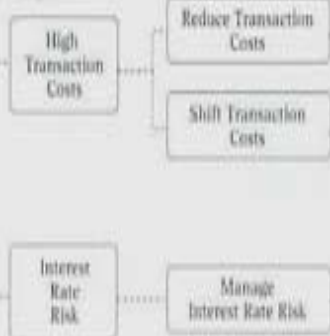
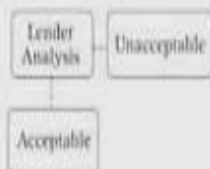
Enhancement Benefits

Enhancement Conditions

New Cash Flow Projection

Project / Lender  
Match Issues

Lender Match  
Gaps



Staff Training/ Specialization

Community Organizations

Consortia / CDCs

8. Technical Assistance

9. Maturity-Linked Markets

10. Secondary Markets

• LISC • NRC/NIH • SBDC • Score  
• Neighborhood Education Programs

• FHLB Advances

• Farmer MAC • Freddie Mac • Glenside Mac •  
• Fannie Mae • NBSA • LHMAC

Reduce Transaction Costs

Financing Flexibility

Enhancement Conditions

Acceptable

Project Decision

Unacceptable