FINAL Subsidy Layering Review
61 Pearl Street, Newton, MA
MetroWest HOME Consortium subsidy: $400,000 – 3 HOME units (all 3 high HOME)
Performed by: Daniel R. Gaulin, subcontractor to FinePoint Associates
November 16, 2010 Updated December 29, 2010

On November 16, 2010, I reviewed the project summary and proforma forwarded by Robert Muollo of the Newton Planning and Development Department. Mr. Muollo subsequently forwarded an appraisal, relocation plan, bank commitment letter, scope of work with preliminary estimate and updated proformas on December 28, 2010.

Executive Summary

Based on the information submitted, the project has been well-conceived by its developer and it is compliant with the underwriting guidelines of the U.S. Department of HUD and the local Subsidy Layering Review adopted by the WestMetro Consortium.

Project Description

The project will consist of the purchase of an occupied 4-unit building and the renovation and reconfiguration of this building into 3 2-BR rental units, one of which will be handicapped accessible. The project will require relocation and $20,800 has been budgeted for this expense. The project developer provided Newton Planning and Development with an itemized budget and it appears that the budget will be adequate. All three units will be high HOME units and will be rented to HOME-eligible tenants at the high HOME rent.

Sources and Uses

The total development cost is projected to be $1,370,000 ($456,667/unit), which includes a $10,000 replacement reserve. The project sources are also projected to be $1,370,000. The sources and uses detailed all financing and all project costs. The overall cost is within the range that is seen for preservation projects in strong market locations.

Notes on Sources

The proforma indicates that there will be $175,000 of bank financing and $50,000 of private foundation support. The developer has provided a commitment letter issued by Cambridge Savings Bank which confirms the details of the loan shown on the proforma. The key terms are an initial 4% interest rate which could adjust as high as 5% after the initial 5 year period at 4%. The proforma has accounted for this change and demonstrates that under reasonable assumptions, the project cash flow can absorb the potential for a 5% interest rate. The remainder of the funds are within the control of the City of Newton or the WestMetro HOME Consortium.

Notes on Uses

The single biggest cost is the acquisition cost. The acquisition cost was documented by a copy of a Purchase and Sale Agreement that was signed on November 5, 2010. The price is $780,000. The City of Newton commissioned an as-is appraisal that was performed by Shepherd Associates; the as-is value as of December 17, 2010 is $780,000.

The project summary contained a description of the work and an estimate of the costs. The description and estimate were prepared by the project's architect.

The soft costs are consistent with what I saw during my nine-year career at DHCD reviewing HOME, HSF and tax credit developments.

The developer fee and overhead is projected at $123,696 or 10% of all other project costs. It is a reasonable fee for a project of this size, complexity and risk. Moreover, to the extent that the fee is at risk, it provides the bank and the City of Newton a bit of a cushion against cost overruns.

Income and Expenses

All income is noted on the submitted operating proforma; note that there are no pay laundry facilities, no commercial units and parking is free. The projected rents are within the HOME limits assuming that the utility allowance for tenant-paid gas heat, gas cooking and unit electricity does not exceed $145/month.

The projections for income and expense inflation are higher than the experience of the recent past. Rather than a 3% increase in income, the developer should consider running the numbers at 2% and rather than 4% for the expenses, 2.5% is more in line with recent expense inflation. However, revision of these underwriting assumptions does not change the overall projection that this is a financially feasible project. The vacancy rate assumption is reasonable: 5%.

The management fee is 7% of gross income, which is reasonable for a small building. If the projections are based on the current owner's actual bills, it would be helpful to have copies of recent insurance, utility and tax bills in the file. The replacement reserve at $500/unit is appropriately higher than on larger projects ($300-350/unit) since this is a moderate rehabilitation of an occupied building. With regard to real estate taxes, to the extent that the building's assessment is a function of its income, the reconfiguration to 3 units and the imposition of HOME limits will likely result in less future income; hence a lower value for the building. The developer may be able to file for a reduction in assessment which in turn will result in lower real estate bills.

The proforma shows that the bank loan has an interest rate of 4% for the first 6 years and a rate of 5% thereafter. These terms are attractive, and the commitment letter confirms that the first adjustment is capped at 5%.

Cash Flow - Return on Equity

The projected initial cash flow is $2,584 per year. In order to derive a total return to the developer on this project, the net present value of the cash flows must be calculated and added to the developer fee and overhead. In this case the net present value of 20 years of $2,584 annual returns at a 9% discount rate (this discount rate is in line with the higher risk associated with a small rental development), results in an additional $23,588, which, when added to the fee taken during the development period of $123,696 results in an overall fee of $147,284 or a still reasonable 11.9%.