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Draft

Risk Assessment and Underwriting Review
54 Taft Avenue, Newton, MA

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Performed by: Daniel Gaulin, subcontractor to FinePoint Associates

In order to complete this assessment, I reviewed the proposal to the City of Newton submitted by the developer, CAN-DO, that is found on the Housing and Community Development Division's website.

Project Summary:

The project consists of the conversion of an existing 3BR single-family located at 54 Taft Avenue into a duplex containing 1 2BR and 1 3BR unit. The construction work will be a mix of renovation to the existing 3BR structure and construction of an addition to the existing structure which will house the 2BR unit.

The HOME request is $125,000. The developer is proposing one low HOME 2BR unit and one non-HOME 3BR unit that will be subject to restrictions from the Community Development Block Grant program and the Community Preservation Funds: a 2-BR and a 3-BR. The proposed HOME amount is 12% of the project's financing which is less than the proportional amount of HOME units (50%), it is also less than the HOME maximum for a 2BR unit.

Market Risk Analyses:

The maximum low HOME rent for a 2BR unit is $1,101 which is the amount carried in the development proforma. The developer correctly applied a $153/month utility allowance for a net rent of $948. The non-HOME 3BR unit has a projected gross rent of $1,775 or a net rent of $1,572 once a $203/month utility allowance is applied. This rent is designed to be affordable to family of 5 at 70% of the area median income.

Taft Street is located in the village of West Newton. There is an active rental market in Newton including apartments in condominiums, single-families and duplex houses. There was no market information in the proposal. However, the information provided in the September 2013 appraisal of 18-20 Curve Street in connection with the Myrtle Village proposal is useful if a little dated. That appraisal indicated that the market net rent for the current unrenovated 3-BR unit is $1,700/month. A review of the rentals shown on the Multiple Listing Service on December 23, 2014 indicates that 2-BRs range from $1,650 to $2,850 and 3BRs range from $2,050 to $3,000+. Newton is a desirable community for rentals due to its reputation for safety and good schools and its proximity to jobs in Boston and along Route 128. The proposed units will be offered at rents at or lower than market units and will be of much better quality than the market rate units they will be competing against due to the proposed renovation; therefore, there is little to no market risk. Moreover, both units are being offered at or below the Section 8 Fair Market Rent which makes the units affordable to all holders of an appropriate sized Section 8 certificate.

Developer Risk Analyses:

This developer is CAN-DO, a Newton-based community development corporation which has also been certified as a HOME Community Housing Development Organization. CAN-DO was founded in 1994 and has completed 13 developments containing 44 units of which 29 are affordable rentals, 8 are affordable homeownership and 7 are market-rate homeownership. CAN-DO's Executive Director has been the in that position for over 14 years, in that capacity she is the organization's project manager as well.

CAN-DO manages some of its properties directly and contracts with the Newton Community Development Foundation (NCDF) to manage two properties.

There is a risk in undertaking development with small organizations such as CAN-DO with one professional staff member. There are factors that mitigate that risk in this case. The project is very similar to previous successfully completed projects. The salary for the position is commensurate with the market for the skills and experience required to do the job effectively making it more likely that a suitable replacement could be found if required.

The financial position of CAN-DO is slowly but steadily recovering from a difficult financial period in the mid-2000's. Therefore, it does not have significant cash reserves, but it has shown an ability to improve the cash flow of its real estate operations so that the organization is projected to run on a near breakeven status in CY2014 and it consistently fundraises $100,000 of its roughly $850,000 annual budget.

The renovation/addition work will be under the supervision of the project architect, Terrence Heinlein. Mr. Heinlein has over 20 years of architectural experience with much of his work concentrated in renovations and additions to older homes in Newton and surrounding municipalities.

A contractor has not been selected yet. There are many firms that are experienced in this type of work.

Project Risk Analyses:

Permitting

There is a degree of permitting risk as CAN-DO will be applying for a Comprehensive Permit under Chapter 40-B. Comprehensive Permit hearings often take place over many months especially if there is neighborhood opposition to a proposal. Even if the local Zoning Board of Appeals grants a permit, the permit is subject to challenges from abutters. This is primarily a risk borne by the developer as delays in permitting can be costly in time and money.

The WestMetro HOME Consortium can minimize the risk to HOME funds by not advancing any HOME funds to the developer until the permit is granted and the appeal period is over. There is some risk to the HOME program to the extent that the Consortium ability to commit HOME funds in a timely manner is jeopardized by either delays in permitting or the inability to obtain a permit for the Taft Street project.

Sources and Uses

The total development cost for the project is projected to be $1,144,029. This project costs include the acquisition value of the property, the construction work to renovate and expand the structure and the related soft costs. The sources are: $15,000 grant from Eliot Church, $60,000 grant from Charlesbank Homes, a $584,029 grant from Newton Community Preservation, a deferred payment loans of $360,000 from the Community Development Block Grant and a deferred payment loan of $125,000 from the HOME program. The sources and uses are in balance and the proforma provides sufficient detail of all financing and all project costs.

The acquisition cost is carried at $590,000 and is based on an accepted offer. The Consortium should obtain a copy of the Purchase and Sale Agreement once it is executed. An appraisal will be needed to confirm whether or not this is a reasonable price.

The construction is estimated by the architect at $357,750 with a 7.75% construction contingency. The renovation work is estimated at $70,200 and the addition is estimated at $287,550 or $261/sf. These are reasonable estimates at this stage of the design development and the 7.75% is an appropriate blend of the 10% contingency that is normally seen for rehabilitation and the 5% contingency normally seen for new construction.

The soft costs total $75,130 or 6.6% of the total development costs which includes architectural costs, legal, title, insurance, real estate taxes, construction loan interest, and a soft cost contingency.

The developer fee and overhead is carried at $83,411 or 7.9% of all other development costs. This is a modest figure for a development of this size and complexity. A fee and overhead of 20% is reasonable for a small project;
therefore, it is appropriate to impute a contributed fee and overhead of $128,713.

The proposal includes a $10,000 replacement reserve. This is an appropriate expense given the known costs of replacing the roof, heating system, cabinets, appliances, etc. over time.

Income and Operating Expenses

There will be two rent tiers: low HOME at 50% of median income and CDBG set at 110% of the Fair Market Rent so that it will be available to Section 8 voucher holders. Both result in rents well below market levels as discussed at length above in the market risk analysis section.

The operating budget of this project is $13,441/unit/year which includes $2,100/unit/year for supportive services and $1,000/unit/year for reserves. The supportive service budget is sufficient to provide roughly 1 hour of services per household per week. The replacement reserve is higher than is typically seen in a multiunit rental but appropriate here as the house will need painting every 7 years or so and a new roof in 20-25 years.

The project was underwritten with a 5% vacancy allowance which is fine given that CAN-DO will have a portfolio of 31 units after the completion of this project.

The real estate taxes are projected at $8,500 which suggests a value of $732,000 which appears to be based on its post-rehabilitation market value not a value as restricted by the rent limits that will be placed on the project by the proposed financing. The Consortium should consider discussing with the Assessor what a post-renovation assessed value might be when the rental restrictions are taken into account.

The operating proforma projects all income and expenses over a 10 year period. The proforma complies with the WestMetro Consortium underwriting guidelines with rents projected at a 2% per year increase and expenses increasing at 3%. However, as structured, the project results in a decreasing cash flow that goes negative in year 11.

In order for the project to maintain a steady positive cash flow, either the rents will need to be increased or the expenses decreased. In order to achieve a steady cash flow, the rents would need to be increased to $44,880 per year which is a net rent of $1,870/unit/year. This is well above the high HOME rents and could only be achieved if the project were to obtain a commitment of project-based rental subsidy that would be willing to pay 125% of FMR which would require the approval of both the local HUD Field Office and the Assistant Secretary for Public and Indian Housing in Washington, DC.

A steady cash flow could be achieved under the proposed rental structure if total operating costs could be reduced to $20,341 per year and the Consortium were to underwrite the 3BR rent at 110% of the 2015 Fair Market Rent. One way that this could be achieved: the annual real estate taxes are reduced from $8,500 to $2,500 and the annual supportive service budget is cut from $5,000 to $4,200.

Cash Flow - Return on Equity

The proposed project has no debt and starts off with a reasonable expense coverage ratio (net income divided by total expenses) 110%. However, as projected, this ratio goes below 100% in year 11 which is another way of indicating that the project will have negative cash flow at that time. Similarly, the projected cash-on-cash return in year 1 on the imputed equity from the donated fee of $128,713 is 2% which is well below HUD and Consortium HOME standards and the projected return decreases slowly and turns negative in year 11.

If the project were successful in reducing expenses, the imputed cash-on-cash return in year 1 on the imputed equity from the donated fee of $128,713 would be 8.9% which is low, but not unreasonable, for a small rental project.

Recommendation

This project is similar to a half-dozen other projects that CAN-DO has done over the years; it has demonstrated capacity to complete and operate the project. However, the project is financially feasible only with a significant reduction in expenses and perhaps some increase in projected rents. This analysis recommends that the only expenses that should be considered for cuts are real estate taxes and supportive services. All other expenses are realistic projections of the actual cost of operating and maintaining the building over time.

The permitting risk of the project can be mitigated by not expending any HOME funds until a comprehensive permit is issued.

The risk associated with CAN-DO’s financial weakness must be assessed in light of its track record of completing projects of this size and complexity for over 10 years. Moreover, the recommended restructuring of the project would result in a reasonable and sustainable cash flow which is good for the project and the organization.