



Housing Assistance Council

**A GUIDE TO
BEST PRACTICES
IN RURAL RENTAL
PRESERVATION**

\$3.00
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HAC, founded in 1971, is a nonprofit corporation that supports the development of rural low-income housing nationwide. HAC provides technical housing services, loans from a revolving fund, housing program and policy assistance, research and demonstration projects, and training and information services. HAC is an equal opportunity lender.

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INTRODUCTION

This guide offers a number of possible best practices for preservation of affordable apartments financed under the Section 515 Rural Rental Housing program of the U.S. Department of Agriculture (USDA) Rural Development (RD).

Since the 1960s, the USDA has operated a rural rental housing program. The Section 515 program has been very successful in its goal of providing decent, affordable housing for the lowest income households in rural America. Yet the program also faces the potential loss of many of its 400,000 plus apartments. Section 515 funding has been cut drastically since 1994, leading to an almost complete absence of any new production. In most recent years, the Section 515 stock has been losing units to prepayment faster than new ones are being built. And at the same time, significant numbers of Section 515 loans are in danger of being paid off, enabling their owners to convert the units to market rents and displace current tenants.

The Section 515 housing program provides mortgage loans to develop rental housing for very low-, low-, and moderate-income tenants. Housing financed by Section 515 is affordable because the loans are for long terms (30 years, amortized for 50 years), carry a basic interest rate of only 1 percent, and can be combined with deep subsidy rental assistance. Section 515 is used to provide rental or cooperative housing for elderly people and for families, congregate facilities, and group homes. It is often used in conjunction with Low Income Housing Tax Credits. The program may also be used to provide equity to certain owners as an incentive to avoid prepayment and preserve affordable housing.

According to RD, about 70 percent (315,000) of the units in its \$11.9 billion Section 515 portfolio are over 15 years old. These existing Section 515 units have accumulated considerable deferred maintenance needs. This problem is due at least in part to a policy of avoiding rent increases so as to cut the cost of Rental Assistance. At the same time, more than 11,000 projects encompassing nearly 290,500 units of Section 515 rental housing are at risk of prepayment. When a subsidized loan is prepaid the apartments may continue to be available to low-income tenants, or they may be converted to market rents or to condominiums. In the latter cases, tenants can no longer afford their homes.

Owners seek to prepay for varying reasons, including the expiration of tax benefits, the burden of increased servicing requirements, the desire of some small project owners to retire and, in some rural areas, an increase in vacancies due to out-migration. Section 515 owners' ability to prepay is restricted by federal law. The details vary depending when a loan was approved, but in all cases RD is either permitted or required to offer owners incentives not to prepay, and in exchange the property continues to be restricted to low-income occupancy for 20 years. These incentives include equity loans, increases in the rate of return on investment, reduced interest rates, and additional rental assistance. In some cases, an owner that rejects the offered incentive(s) must offer the project for sale to a nonprofit or public agency.

This guide has three parts. The first covers the background of the federal program and its preservation components. The second is on the role of state agencies. And the final section offers a number of case study descriptions of successful preservation transactions. Most of the material in this report is taken from two recent issues of the Housing Assistance Council's magazine, *Rural Voices*.

THE ROLE OF FEDERAL PROGRAMS

Preserving RD Rural Rental Properties: The Challenge and the Opportunity

by Patrick Sheridan¹

Housing opportunities have improved greatly for many Americans over the past few years. Affordable rental housing in rural areas has not seen significant growth in new units, however. Increasing affordable rental opportunities for rural Americans is particularly important for two groups: families just starting out who cannot take advantage of improved homeownership possibilities and elderly people who are no longer able to take care of their single-family homes.

Rural markets present significant underwriting challenges to lenders, secondary market participants, and equity investors. Limited employment and population bases often cause these parties to shy away from participating in rural deals. Small unit numbers limit the opportunities for profit by lenders and for-profit sponsors. Owners find that the small sizes and limited markets make operating efficiencies difficult to attain. When there is a choice between new construction of a larger development in a metropolitan area or a small project in a rural area, the large development wins nearly every time.

As new construction of affordable rural rental developments continues to be limited by a combination of economic pressures and reduced federal funding, preserving the affordability of existing rural housing is more important than ever. Most rural rental properties are financed under the USDA Rural Development Section 515 program. With high occupancy levels, low average incomes, and the typical resident being a single or widowed elderly woman, such affordable housing is critically needed.

In addition to the challenges presented in building new affordable rural projects, working under the Section 515 program presents additional issues. The ability to take a return on investment is tightly limited under the Section 515 program. Secondly, long processing times impede potential sponsors' acquisitions of properties. Lastly, lack of federal direct loan funds for rehabilitation or seller equity requires buyers to spend time shopping the market for third party funding.

Opportunities to preserve Section 515 properties can take two forms. The first preservation need is an election by the current owner to prepay the loan, either to take advantage of favorable market conditions that would support an increase in rents, or to eliminate the requirement to comply with burdensome federal regulations. The other is the need to recapitalize older properties that have reached points in their life cycles when major system components require replacing. Both situations present challenges to owners and purchasers to find exit strategies or funds to retain the apartments as affordable.

The number of sponsors willing to undertake the acquisition and rehabilitation of older Section 515 projects is limited. Few for-profit sponsors are able to do volume acquisitions of RD projects; therefore the bulk of the job of preserving the rural properties falls on the nonprofit sector. Nonprofits often look upon such acquisitions as part of their mission. Long-term ownership goals

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and the ability to accept use restrictions and limited returns make nonprofits the likely answer to volume preservation.

Volunteers of America has committed itself to acquiring properties in need of preservation as one way of ensuring the nation has adequate affordable housing for seniors, families, and people with disabilities. As a national, nonprofit, spiritually based organization in existence for more than 108 years, Volunteers of America has a long history of providing services to individuals, families, and communities, including the ownership and management of affordable housing. Nationally, Volunteers of America and its affiliates own and operate more than 250 affordable housing communities in 31 states that are home to more than 25,000 people. The organization has recognized the specific need to preserve rural properties, an area that many of the larger organizations and firms active in preservation activities have shied away from. With the recent acquisition of its first Section 515 property, Adirondack Apartments in Saranac Lake, N.Y., Volunteers of America saw an opportunity to help meet the goal of helping to preserve rural affordable housing.

It is vitally important that successful models for preserving Section 515 projects be developed. The challenge in acquiring RD properties is finding a way to provide the owner a fair return, cover the purchaser's transaction costs, and have adequate funds remaining to carry out a moderate rehabilitation plan. Paying an owner the full value of a property provides no room within the appraised value to finance transaction costs. Additionally, improvements made to the buildings seldom increase property value dollar for dollar. If owner concessions are unavailable, debt-free or low-cost funds are critical to finance the transaction.

There are several models that do work. Each has its advantages and disadvantages. The best model, from both the economic and experience standpoints, is use of the Low Income Housing Tax Credit for acquisition and rehabilitation. Another model is the acquisition of partnership interests, allowing a new sponsor to step into the shoes of an existing partner in an ownership entity. Finally, a third model uses servicing tools RD has available, such as subordinating its mortgage, along with new third party loan funds.

Low Income Housing Tax Credit Model

Using the LIHTC in acquisition and rehabilitation provides debt-free capital to accomplish many of the goals of a successful transaction. After negotiating a sales price with the existing owner, the proposed buyer simultaneously applies for tax credits with the state credit agency and a transfer of the debt with the applicable servicing office of RD, using either 4 percent or 9 percent credits. If 9 percent credits were applied for, the acquisition piece of the transaction would be eligible for 4 percent credits while the rehabilitation piece would qualify for 9 percent credits. The RD debt must not be restructured or the entire transaction is categorized as a 4 percent transaction. However, there may be deals where it is more important to restructure the RD debt to a lower interest rate or a longer term. Pro formas should be developed using both scenarios to determine which would provide the greatest benefit to the transaction.

Using tax credits allows several needs to be met. The typical RD LIHTC transfer involves the RD debt being transferred to the purchaser, and the tax credit equity being used for three primary purposes – paying some if not all of the seller's exit taxes, the buyer's transaction costs and developer fee, and rehabilitation costs if only light rehabilitation is needed. If a larger

rehabilitation is needed, new loan funds can often be included in the pro forma. If those new funds do not come from RD, obtaining them from a third party usually involves an agreement by RD to subordinate its debt to the new lender.

Acquisition of Partnership Model

The second acquisition scenario involves parties who are part of an ownership entity where it does not make sense to extinguish the entity through an outright sale of the property. Such deals may involve a partnership that is only partway through its tax credit compliance period. If a general partner wishes to exit, an opportunity exists for a nonprofit sponsor to step into the shoes of the exiting partner.

These transactions require a different type of evaluation. There is often little annual distribution in existing partnerships. There would be no opportunity to earn developer fees as no real estate sale takes place. The economic benefit to a buyer is primarily the right to select the property manager – assuming that a related party will become the manager – and whatever residual equity may result from a future sale. For these reasons, nonprofit sponsors with long-term ownership and preservation as a mission are the most logical parties to take on such transactions.

Conducting due diligence of an acquisition of a partnership interest requires a market study, an environmental review, and a real estate appraisal. In addition, a determination of the value of the partnership interest itself is invaluable. An accounting firm or real estate counsel familiar with affordable housing partnership documents and operations can complete a valuation. The valuation provides an estimate of the present value of the flow of possible incomes from the partnership interest, including factoring in future liabilities the interest may have agreed to in the syndication.

Volunteers of America's experience in ordering partnership valuations has helped us make informed decisions not to take on some transactions, while showing us the value in others. In one recent deal, the partnership interest appeared to have significant value on the surface. Our analysis, however, revealed that the selling partner had made commitments to the partnership for future payment of a deferred developer fee, which eliminated completely any value to the partnership interest.

RD Servicing Tools Model

Lastly, the use of third party funding sources not in conjunction with LIHTCs presents an opportunity for acquisition of rural properties with minimal rehabilitation needs in stable markets. Several different sources are available for third party funds, from HOME funds to state agency direct loan funds, or from tax-exempt private activity or 501(c)(3) bonds to private lender loans, most recently being purchased by secondary market sources. RD will routinely subordinate its interests to those of reasonable third party funding sources. The challenge is to obtain loans with the longest term and lowest cost, allowing basic rents to remain at or below area market rents. Underwriting by third party lenders often still presents problems, as most lenders are not yet comfortable with rural properties. To provide a level of assurance to the lender, it is important to make sure the lender understands that with RD in the second mortgage position, an extra layer of protection is provided should there be a default. In addition, the loan-to-value ratio of the first position loan is often less than 50 percent.

Other models should be explored for preserving rural properties, including standardizing the concept of portfolio transfers. There is much work remaining, but the good news is that RD, the U.S. Department of Housing and Urban Development (HUD), and many in Congress, along with lenders, secondary market participants, and foundations recognize this need. If all parties work together, it is possible to preserve the rural portfolio of affordable properties.

Lessons From HUD's Preservation Process

by Don Chase and Julie Graves¹

[Editor's note: This article was written before substantial revisions in RD's regulations for multifamily housing, including prepayment and preservation, took effect on February 24, 2005, and Administrative Notice 4010, issued on September 23, 2004, altered the process for transferring ownership of multifamily properties (outside the prepayment context). New procedures may have mitigated some of the problems described in this article.]

Over 300,000 units of affordable housing were lost nationwide between 1995 and 2003 when many private property owners prepaid their government-restricted mortgages, redeveloped the land, or converted the apartments to market-rate housing.

The good news is that since 1999, HUD has been making significant headway in preserving many of these units through its Mark to Market program. But even as HUD-financed units are saved, each year scores of opportunities are lost to preserve thousands of units financed by the U.S. Department of Agriculture's Rural Development (RD) Housing and Community Facilities Programs.

Some USDA RD-financed housing has been preserved, but rural preservation has faced an uphill battle because of what we believe are unwieldy rules and staff inexperience with mixed-finance deals. The preservation process for RD properties takes at least two years, and in at least one case it took almost seven years from start to finish. In contrast, refinancing and transfer of HUD-financed housing through the Mark to Market program takes an average of one year.

Why the Difference?

Congress realized that restructuring and preserving HUD-financed housing would be a huge undertaking, so it created an organization of experts specifically charged with this effort. The result was the Office of Multi-Family Housing Assistance Restructuring (OMHAR), later wrapped into HUD as the Office of Housing Preservation (OHP). Staff at OMHAR were hired for and trained to have the specific financial and regulatory expertise to administer the program efficiently and effectively. In contrast, RD staff have had to juggle restructuring and preservation efforts with day-to-day loan servicing work.

OMHAR rules were developed to take financing and funding realities into account. In contrast, the RD process seems cumbersome and not user-friendly. And while OMHAR's rules encourage maintenance of properties and realistic rental subsidies, RD regulations do not.

¹ Don Chase is Director of Multi-Family Housing and Julie Graves is Director of Development at the Kitsap County Consolidated Housing Authority in Silverdale, Washington.

Problems with the RD Program

Following are some specific examples of the difficulties of RD's program.

Rules vary by state

USDA Rural Development State Offices, which administer RD programs including prepayment, have different rules than the National Office. This can be confusing, resulting in a lengthier and more costly process.

Outmoded regulations, lack of funding

RD regulations prevent the proposed lender from ordering the property appraisal. RD staff must order the appraisal, and the required format often does not meet the proposed lender's requirements. In the Windsong project, described below, the lender had to order an additional appraisal to meet its lending requirements.

These properties usually need a significant amount of rehabilitation due to deferred maintenance, but USDA's process does not take into account that the buyers of these properties need extra funding to make the deals work financially. RD just does not have funds available for this purpose.

RD also has strict regulations regarding project budgets. Basic rents for the project cannot exceed what is needed to pay for basic expenses and debt service. In many cases, RD staff are reluctant to have the amount of debt against a project increased, as this will require a rent increase.

In addition, while HUD projects generally have project-based rental assistance for 100 percent of the units, many RD Section 515 properties do not. This means that an increase in the property rents could result in the low-income tenants having to pay rents that are no longer affordable.

Unrealistic timelines, staff workload

RD's Section 515 transfer and preservation process is so cumbersome that the timeline usually cannot be met. And if the deal does not close within 12 months – for whatever reason – the entire process must start all over.

A case in point is the Windsong Apartments, a 36-unit preservation project in Poulsbo, Washington, which took our organization, the Kitsap County Consolidated Housing Authority, seven years to acquire. The delay meant more staff time, which not only cost the housing authority money, but also kept us from preserving other housing. And as the process dragged on, the buyer had to pay for new appraisals and other third party reports, including studies that had to be done to meet new, changing regulations.

Because the property was under a purchase and sale agreement, the owner had no incentive to address deferred maintenance issues, so roofs and decks continued to deteriorate.

One of the delays occurred because RD required a unit-by-unit inspection. Due to workload issues, agency staff often delayed beginning the inspection process for 90 days. Frequently, after the inspection was made, another 90 days would pass before the inspection report was

completed and sent out. In one case, over a year went by before the inspection report was sent to the owner and buyer.

Lack of experience with mixed or layered finance deals

Historically, Section 515 projects were financed entirely with RD funds, so staff do not have enough experience to facilitate mixed finance deals. We've found the best way to preserve this housing is for a nonprofit to buy it and use 4 percent Low Income Housing Tax Credits. But RD staff often do not have the experience or decision-making authority to allow this to happen.

Why HUD's OMHAR Program Works

In contrast, OMHAR has developed a track record of preserving and restructuring project-based Section 8 buildings. Because it is a single-purpose organization, its staff have the financial and regulatory expertise to administer the program efficiently and effectively.

OMHAR assigns specific properties to Participating Administrative Entities (PAEs), which are public agencies, nonprofits, and private organizations chosen for their expertise in mixed use financing, as well as their track records in financing and preserving affordable housing. Kitsap County Consolidated Housing Authority is one of about 20 PAEs nationwide. PAEs order the appraisals, do the local market studies, and share this information with the owner in a timely manner, so he or she can begin to explore options.

PAEs also evaluate the physical condition of the property, a step that can take RD staff up to a year to complete. We then make recommendations for any necessary rehabilitation, and work with the owner to develop a financial restructuring plan. Often, the private owners are elderly and want to sell their property, and in these cases, the PAE may help the owner find a nonprofit organization or housing authority to buy it, then put together the financing for the sale to ensure long-term viability of the apartments.

KCCHA and Signet Partners were assigned the restructure and transfer of the Bicentennial Apartments Village, a 100-unit property in Rock Springs, Wyoming. The owner of 25 years wanted to sell and the Western Region Non Profit Housing Corporation, headquartered in Salt Lake City, wanted to buy. KCCHA, Signet, OMHAR, the owner, and the buyer worked together quickly and seamlessly, using a combination of Low Income Housing Tax Credits from the Wyoming Community Development Authority and a restructuring of the existing debt. Not only will 100 families continue to have affordable housing, but the building will be substantially rehabilitated.

There are several reasons HUD-financed housing preservation deals get done faster:

- △ OMHAR (now OHP) – which administers the agency's housing preservation effort – was created specifically to reduce the cost of project-based Section 8 housing, and to preserve and recapitalize existing properties. As a result, its staff were hired and trained to have the specific financial and regulatory expertise to administer the program efficiently and effectively.
- △ OMHAR outsources the actual financial restructuring, property transfer, and rehabilitation recommendations to the PAEs. These organizations have contractual obligations to complete the deals within a specified period.

- △ Staff at OMHAR are held to the same deadlines as the PAEs.
- △ OMHAR's rules were developed with the help of private and public organizations with real-world experience in this area. As a result, they take into account that many of these properties will be transferred to nonprofit owners, who need to be able to take advantage of additional funds in the form of tax credits, Federal Home Loan Bank grants, state housing trust funds, and HOME and Community Development Block Grant dollars.

It is vital to preserve as many Section 515 units as possible. To do this, RD must revamp its process to ensure speed, certainty, and decisiveness. We believe it should take advantage of the lessons learned through OMHAR's Mark to Market program to:

- △ create a cadre of experts empowered to make decisions and grant waivers when necessary, with timelines and required deliverables;
- △ revise RD rules to reflect real-world realities and streamline processes;
- △ allow staff to authorize restructuring of debt;
- △ empower the staff to set rents at realistic levels, which take rehabilitation and maintenance costs into account; and
- △ allow for second mortgage financing to take rehabilitation costs and rent subsidies into account. Empower staff to forgive debt when appropriate.

We believe the experience gained during the past five years by OMHAR and the PAE network is invaluable and – with the right legislation and with appropriations – can be adapted for RD. The time to preserve and potentially transfer properties is now. It is imperative that these changes be made quickly to avoid any delays involved in setting up a new organization, and the extra time and expense of training staff. Thousands of low-income and disabled residents need safe, decent housing and are counting on us.

Section 538 Guaranteed Loans: A Resource To Help Preserve Section 515 Developments

by Arlene Nunes¹

The Section 538 Guaranteed Rural Rental Housing Program (GRRHP) was authorized by Congress in 1996 as a pilot for the development of affordable multifamily rural rental housing, and was made permanent in 1998. The GRRHP was established as a partnership between USDA and public and private lenders. USDA provides a 90 percent guarantee on losses to program lenders who originate, underwrite, and service loans for new construction and acquisition with rehabilitation of multifamily rental housing in rural areas. The GRRHP started with modest funding levels early on but steadily grew over the years. Fiscal year funding in 1996 was \$14 million, and in 2007 it is \$100 million.

The GRRHP has become an attractive and necessary alternative to the use of conventional financing for the development of affordable housing. Regulations offer flexibility in lender underwriting and servicing, an interest rate buy-down feature – which has proven to be particularly important in an escalating interest rate market – and benefits to lenders and developers alike. Among developer incentives offered by the program are minimal borrower

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equity requirements of 10 percent for for-profit entities and 3 percent for nonprofits and public bodies, no Davis-Bacon requirements, and unlimited return on investment. Lender benefits include community reinvestment credit, the ability to sell GRRHP loans to the secondary mortgage market and private investors, and flexible underwriting standards and oversight.

In terms of affordability and project feasibility, the GRRHP permits a minimum 1.15 debt service coverage ratio, allows for a 40-year amortization schedule, and offers interest credit on \$1.5 million of the loan amount down to the long-term monthly applicable federal rate at the date of loan closing. These program features make rents affordable and projects achievable. Tenants with incomes up to 115 percent of the area median, adjusted for family size, can qualify for the housing units. The program limits utilities expense to 30 percent of the qualifying rent. More importantly, income qualification requirements apply to tenants only at first-time occupancy. Once qualified, tenants may stay in the housing even if their incomes increase.

The program's income eligibility requirement has earned the GRRHP an undeserved reputation as a mechanism for the development of housing on the periphery of large metropolises where people have higher incomes. Geospatial data on the program indicate that Section 538 guaranteed properties are located in rural areas, often near Section 515 projects, serving low- to very low-income populations.

The following two examples showcase the program's flexibility in improving and preserving the housing stock of low- to very low-income tenants. The program's 40-year amortization schedule, the interest rate buy down, 4 percent or 9 percent Low Income Housing Tax Credits, and tenant-based housing vouchers are complementary factors that achieve affordability for very low-income tenants.

Ownership Transfer with Old Loan Subordinated

Sunrise Villas Place is a 27-year-old property located in northern Maryland, where the median income is \$47,150. Sunrise Villas consists of 28 one-bedroom units and 28 two-bedroom units. Construction was initially financed in 1980 with a Section 515 loan in the amount of \$1,308,720 with a term of 50 years and a subsidized interest rate of 1 percent. In 1998, the property was approved for a subsequent Section 515 loan in the amount of \$234,000 with a term of 50 years at an effective 1 percent rate. The 20-year restrictive use agreement imposed by the Section 515 program was due to expire on April 18, 2017.

Before the property was transferred in early 2007, rents were \$498 for a one-bedroom unit and \$606 for a two-bedroom apartment. Of the total 56 units, 39 received Section 521 Rental Assistance. The property had 17 income-restricted units without RA. As expected, the debt service coverage was marginal at 1.1. The property struggled to meet the reserve requirement of \$192 per unit per month.

The injection of Section 538 guaranteed capital served to improve the physical state of Sunrise Villas Place and preserve affordable housing in a much needed area. This was achieved through a transfer of the property and assumption of Section 515 debt to a new owner. Both the former and new owners are for-profit corporations. The Section 538 guaranteed loan in the amount of \$2,177,000 was used for acquisition and rehabilitation; an equity payment of \$575,000 was

made to the previous owner and \$1,602,000 covered hard and soft costs, including the developer fee.

The Section 515 debt was subordinated to the Section 538 guaranteed loan with new loan terms. The new owner assumed \$1,389,167 of Section 515 debt at 1 percent for a 30-year term amortized over 40 years. The Section 538 guaranteed loan of \$2,177,000 shares the same term and amortization schedule as the Section 515 debt. The rate for the Section 538 loan, however, is 6.9 percent. The interest rate on the first \$1.5 million of the Section 538 loan was reduced with interest credit to 4.7 percent while the balance of the note remains at the 6.9 percent rate. Rents increased from previous levels, but RA transferred with the previously designated RA units to alleviate the additional rent burden on tenants. The rent is now \$691 for a one-bedroom unit and \$793 for a two-bedroom.

The new financial structure of Sunrise Villas Place addressed several pressing issues facing the property. The new structure enabled the previous owner to transfer the property and receive an equity payment. The new financing permitted much-needed rehabilitation of an older Section 515 complex and the funding of reserves in the amount of \$465 per unit per month, an adequate figure based on a Capital Needs Assessment. The debt service coverage was set at 1.15. The restrictive use provisions were extended for an additional 30 years, ensuring that the property remains as affordable housing. And the impact on rents was addressed through the continuation of RA for the already existing 39 RA units. The new owner agreed to cover the difference in rent from previous levels for the 17 non-RA units from return to owner funds.

Prepayment with Acquisition and Rehabilitation

In the case of the Cypresswood Apartments in Pearson, Georgia, the Section 538 guaranteed loan was used to prepay the Section 515 debt with a very favorable outcome for property and owners. Cypresswood Apartments was built as a 28-unit family project in partnership with HUD's Section 8 program in an area where the median income is \$22,188. The original Section 515 loan was made in 1982 in the amount of \$630,800 amortized over 50 years at an interest rate of 9.5 percent. Reserve requirements were \$225 per unit and debt service coverage was merely at 1. But the Section 8 agreement kept the rents affordable. A one-bedroom unit was \$436, a two-bedroom was \$482, and a three-bedroom was \$554.

The new for-profit owner of Cypresswood Apartments was able to refinance and rehabilitate the property using \$1,916,249 in tax credits and a \$1,010,000 Section 538 guaranteed loan. Tax credit funds were used to make an equity payment of \$192,542 to the original owner, cover hard and soft costs, and fulfill reserve and equity requirements. The Section 538 guaranteed loan was used to pay off the \$612,349 balance on the existing Section 515 loan and to cover development and some construction costs. The lender's note rate was 7.41 percent. Interest credit from the Section 538 program reduced the interest rate to 4.91 percent on the entire guaranteed loan amount. The debt service coverage increased from 1 under the Section 515 program to 1.17 with the new financial structure. Replacement reserves per unit also increased from \$225 to \$333, providing a cushion for unexpected events.

The impact on rents was negligible. Rents for one-, two-, and three-bedroom apartments increased by \$20, \$40, and \$60 respectively. However, HUD contract rents covered the new rent structure when the new owner renewed the restrictive use agreement with HUD for 20 years.

The benefits realized by the property are obvious in the debt service coverage ratio, the increase in reserves, and the new physical state of the project. The new owner benefited from the removal of Section 515's restrictions on return to owner when the Section 515 loan was paid off. And the benefits to affordable housing were realized with the renewal of the HAP agreement for 20 years and the Section 538 deed restriction for the original Section 538 loan term of 40 years.

Conclusion

While these examples are evidence that the GRRHP can be an effective tool in the preservation of Section 515 housing, the Section 538 program is not able to address all the specific needs of properties in the Section 515 portfolio in every situation. Nonetheless, it is a financing option worthy of consideration for the benefits and flexibility it offers to developer, lender, and project.

THE ROLE OF THE STATES

State Agencies Dig Deep to Preserve Rural Properties

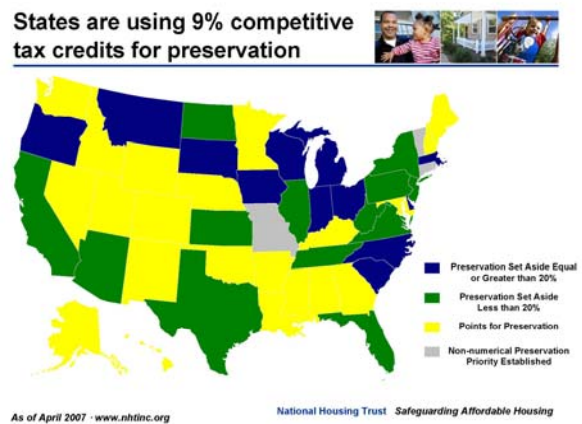
by Tracy Kaufman and Todd Nedwick¹

Preserving affordable housing has become the essential first step in solving the housing dilemma facing communities all across America. Affordable rental homes are an irreplaceable national resource. In rural America, the Section 515 program provides homes to more than 400,000 families and seniors who have an average annual income of only \$10,000. Preserving this housing most often means addressing the physical needs of deteriorating properties. Two-thirds of the Section 515 portfolio is now more than 20 years old and many properties do not have adequate cash flow or reserve accounts to pay for essential rehabilitation costs. With federally subsidized housing developments often the only affordable housing available in our nation's rural areas, preserving and improving this housing has become more urgent.

Fortunately, despite a number of challenges, affordable rural housing is being preserved, in no small part because state and local policymakers are recognizing the importance of reinvesting in the existing affordable housing stock. A major obstacle to preservation is securing financing to address the property's physical needs, especially since budget constraints have limited the availability of federal funds for property rehabilitation. State and local agencies have been meeting this challenge by digging deep to find needed resources.

State Housing Agencies Continue to Stress Preservation

Partnerships with state housing finance agencies are essential for preserving affordable housing. (See case study on Clover Patch Apartments, in case study section of this report, below.) Tax credits provide an increasingly important source of funding to facilitate the preservation of rural properties. The preservation landscape has changed rather dramatically in only the last several years. Just five years ago, only a handful of states prioritized preservation in their Low Income Housing Tax Credit allocation plans. Today, 46 states prioritize preservation through points or a specific preservation set-aside in their 9 percent competitive tax credit program (see map, right). As a result, the number of affordable units preserved increased from 20,000 apartments in 2000 to more than 63,000 in 2006. Over the last four years, housing tax credits have helped preserve and improve more than 215,000 affordable apartments.



¹ Tracy Kaufman is Director and Todd Nedwick is Assistant Director of National Preservation Initiatives at the National Housing Trust. The John D. and Catherine T. MacArthur Foundation has helped to support NHT's activities.

Other recent developments include the following.

- △ 25 states now maintain competitive tax credit set-asides explicitly for preservation.
- △ In just the past year, three states – Florida, Kansas, and North Carolina – created new set-asides for preservation in their competitive Low Income Housing Tax Credit programs.
- △ A majority of states now dedicate a portion of their 4 percent tax credits and private activity bonds to preservation.
- △ In addition to targeting tax credits to preservation, most states have recognized the importance of supporting affordable housing in rural areas and have incorporated incentives for rural development in their tax credit allocation plans. Forty-five states now include a priority for rural development for both new construction and preservation in their tax credits qualified allocation plan (QAP). For example,
 - 29 states include tax credit set-asides specifically for rural proposals;
 - 20 states award points to rural proposals;
 - four states offer a non-numeric preference for rural proposals; and
 - 12 states combine two or more strategies.

Six states specifically target rural preservation in their QAPs. For example, Colorado awards points to proposals aimed at saving Section 515 properties that are within two years of their mortgage maturity. Indiana, Iowa, and Montana award points for rural preservation projects. Finally, North Carolina provides a \$750,000 set-aside for rural preservation proposals.

State Agencies Confront Barriers and Develop Strategies for Rural Preservation

In addition to using tax credits, state housing agencies are finding solutions to preservation challenges that are particular to rural communities. Financing rural rental housing preservation is complicated by the small size of rural properties; the average size of a Section 515 property is around 30 units. In addition, many states identify the lack of local capacity as another barrier to rural preservation.

To meet these challenges, states have composed a variety of strategies for preserving existing affordable rural housing. Where developers use tax credits, states endeavor to group a number of rural properties together in one transaction. The New Mexico Mortgage Finance Authority creatively treated several rural properties, owned by the same entity, as one scattered site development. Five scattered site Section 515 properties were “rounded up” and bundled together in one bond issue. The consolidation of the properties dramatically reduced transaction costs and ultimately led to the preservation of a valuable Section 515 portfolio.

To address concerns about lack of capacity, some states pair local nonprofits with national nonprofits to preserve rural housing portfolios.

Housing Trust Funds Support Preservation

Another increasingly important source of resources for preservation is local and state housing trust funds. Eighty percent of all housing trust funds support affordable housing preservation, according to the Housing Trust Fund Project at the Center for Community Change. The Center recently released its *2007 Housing Trust Fund Progress Report* which illustrates the growing impact of state, city, and county trust funds on affordable housing.

Housing trust funds are especially important for affordable housing development because they provide a continuous stream of funding not dependent on annual appropriations and often represent the most flexible funds jurisdictions have available for affordable housing. There are currently 600 housing trusts nationwide that contribute \$1.6 billion each year towards critical housing needs.

Nearly all state housing trust funds make financing or grants available for preservation. Some states, including the District of Columbia, Florida, Indiana, Montana, Utah, Vermont, and Washington, prioritize preservation as a preferred activity. At least one state, New Jersey, goes even farther by setting aside a specific portion of its trust fund money for affordable housing preservation activities.

In Utah, the state housing trust fund has become an important source of funding for preserving the state's invaluable supply of Section 8 and Section 515 subsidized rental units. According to Shellie Goble, multifamily director for Utah's Olene Walker Housing Loan Fund, the fund's success can be attributed to the recipients' ability to combine trust fund loans or grants with other funding sources. "Historically we've found that our projects leverage up to \$11 in other funding sources for every dollar they receive from the Fund," she said.

Other State and Local Preservation Tools

Finally, states, cities, and counties are dedicating additional resources, outside of tax credits and trust fund dollars, to the development and/or preservation of affordable housing. Most states use HOME funds to finance preservation. Other resources include providing predevelopment and bridge loans, allowing owners equity take-outs, providing tax incentives to owners who agree to maintain the housing as affordable, developing nonprofit CDFIs that fund predevelopment or provide bridge financing for preservation transactions, and allocating state and local tax revenue, as well as many other tools that are documented in a preservation database available on the National Housing Trust's website (www.nhtinc.org).

CASE STUDIES

Tips for Successful Preservation Deals

*by presenters at Preserving Rural Rental Housing: A Practitioner's Conference,
St. Peters, Missouri, May-June, 2007*

- △ Communicate, communicate, communicate! Figure out early who the players are: funding sources, community leaders, tenants, architect, and others. Talk with them often and build relationships. Designate a single point of contact and ask other parties to do the same.
- △ Assume everything that can go wrong will.
- △ Use expert help, especially if you are new to preservation. Do not take on too much too fast.
- △ Be prepared. For example, review funding sources' regulations and guidance in advance and be ready to address the issues that will concern them. Identify key deadlines early. Determine early how each party will want appraised value to be determined, and when. Review carefully the capital needs assessment, a major factor in the budget of every preservation project.
- △ Be flexible. Numerous changes will be needed along the way in each deal. Also, each deal is unique, so what worked last time may not work now.
- △ Be creative. Find ways to make the deal work (within the regulations, or at least within RD's waiver authority). Never say never. If trying something new means more work, consider that it may be worth it in the end.
- △ Simplify the deal where possible. For example, if multiple properties are involved, use one capital needs assessment provider, one attorney/title insurance company, and one appraiser.
- △ Consolidate multiple properties located close together. Consolidation will allow sharing management, transferring Rental Assistance between related properties, and the like. For a portfolio transaction, RD prefers to do one deal first as a trial run.
- △ Learn as you go. If something did not work out in your last deal, address it early in future deals. Build on what did work and what has worked for others. Offer suggestions for improvement. Attend as many training sessions as possible.

California: Rural Preservation and Resident-Based Advocacy

by Dewey Bandy¹

The devastation of the nation's affordable housing inventory through the conversion of subsidized rental units to market rate housing is one of the biggest challenges facing rural housing advocates. In responding to the current wave of prepayments and Section 8 opt-outs, it is critical that communities, advocates, and developers employ every tool available to preserve this critical local and national resource.

Advocates nationwide have worked to ensure that preservation is prioritized by federal and state funding programs and that dedicated short-term loan funds are available to purchase or "warehouse" at-risk projects until permanent funding can be secured. Other initiatives have supplemented the meager protections of federal law with state and local ordinances designed to strengthen notice requirements, notify potential preservation purchasers, and provide a brief period for preservation purchase offers before developments are sold or converted. Nonprofit technical assistance providers such as the California Housing Partnership Corporation have helped nonprofit developers and community organizations navigate the complex financing required to preserve properties that would otherwise prepay and opt out of restrictions.

These initiatives have contributed greatly to the preservation of at-risk housing. However, the emphasis on housing programs, legislation, and strengthening the capacity of nonprofits to undertake preservation purchases has tended to overlook an important approach to preservation – resident-based advocacy. As the case study below demonstrates, residents themselves can constitute the driving force in preservation. Especially when a negotiated preservation purchase is not possible, resident-based advocacy may be the only way to preserve a property.

The Ellison Apartments were developed in the early 1970s in the small town of Red Bluff, California, with a HUD-assisted Section 236 mortgage. By 2000 the Ellison's 94 units, located in one of the poorest and least populated rural areas in California, constituted 12 percent of all the affordable units in Tehama County. The California Coalition for Rural Housing (CCRH) became involved in 1995 when the owners decided to sell the property under the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA). LIHPRHA granted qualified nonprofit housing organizations a strong right of first refusal before any prepayment could occur, funded the sale and rehabilitation of the property, and required resident endorsement of the buyer. Resident organizations and technical assistance intermediaries such as CCRH received grants to facilitate resident participation in the LIHPRHA process.

When CCRH began working with residents in late 1995, the Ellison was poorly managed, badly maintained, and a center for drug dealing in Red Bluff. Progress was not easy, but through persistent outreach, training, and technical assistance, the Ellison Residents Association was formed in early 1997. Aided by CCRH, the residents held regular meetings, elected a resident board, produced a resident newsletter, and received a HUD capacity development grant. Resident initiatives were undertaken to address drugs, crime, maintenance, and the lack of resident services. As a result of these organizing initiatives, the residents began working with a local nonprofit developer, Community Housing and Improvement Program (CHIP), and endorsed CHIP's purchase of the property in 1996.

¹ Dewey Bandy is Deputy Director of the California Rural Housing Coalition in Sacramento.

Unfortunately, when LIHPRHA was repealed in late 1996 and funding ended for HUD preservation sales the property went into a downward spiral of physical decay and financial collapse. The management presence on the property gradually disappeared. Massive electricity bills due to master-metered utilities rendered a market sale or conversion infeasible and created an operating deficit that eventually led the property into default.

Despite the end of LIHPRHA, the Ellison Residents Association (ERA) remained active and continued to pressure HUD to take action to preserve the property. These efforts bore fruit when HUD, in early 1999, agreed to hold off on foreclosure and allow CHIP to pursue a tax credit purchase of the property. HUD warned, however, that should CHIP not receive tax credits, the department would foreclose and auction off the property.

In the summer of 1999, the long odyssey to save the Ellison seemed finally to have ended when CHIP narrowly missed obtaining a tax credit award. By now the property had become virtually uninhabitable, overwhelmed with drug dealing and having almost no management presence. Many residents simply had enough of the social and physical blight and began to move out. To top things off, the project was approaching the realm of technical and financial infeasibility due to the massive amount of rehabilitation needed and a rapidly approaching deadline on the use of HOME funds committed by the city to CHIP for the tax credit deal. HUD was adamant that it would now sell the property in foreclosure auction. Since this meant simply selling the property to another absentee slumlord and effectively ending affordability restrictions, the end seemed near. But 2000 was to prove a new millennium for the Ellison and provide a lesson to HUD on grassroots power.

With support from CCRH organizers, the ERA launched an aggressive community-based advocacy campaign to save the Ellison. The strategy was to combine litigation with community/political pressure to force HUD to transfer ownership to CHIP. The legal part of this strategy demonstrated one of the most direct forms of resident preservation advocacy – plaintiffs in a lawsuit by Legal Services of Northern California.

Residents were essential for the legal strategy because, since they were directly affected, a judge was not likely to throw the case out of court as might happen if an outside organization or nonprofit developer sued. But serving as plaintiffs was much more than letting a lawyer represent them in court. It required enormous physical and moral courage. As plaintiffs, the ERA leaders and membership had to remain in miserable, unhealthy, and dangerous housing conditions. This group of poor, disabled, elderly, and working class leaders with meager financial resources had to resist the easy temptation of Section 8 vouchers offered by HUD, and instead challenge a powerful and seemingly omnipotent federal agency. While courage is not easily figured into a pro forma, it was one of the most essential ingredients in this struggle and ultimately had to come from the residents.

We should not forget that as professionals, at worst, we usually risk bruised egos if a preservation deal or advocacy effort fails. For residents the risk is eviction, lack of physical safety, and homelessness. Rural housing advocates should remember that it is precisely this level of courage that in some cases can make the difference between preservation or prepayment. Resident advocacy proved essential for winning community and political support in this politically conservative rural community. To lobby HUD successfully during the Clinton

Administration, the support of California's two Democratic U.S. Senators was essential. But when contacted, their staffs made it clear that they would not be willing to intervene without strong local political support.

It was here that the stories, passion, and commitment of the residents won over the conservative city council, county board of supervisors, and local congressman. In public and private meetings, the presence and stories of residents moved the issues from simply abstract and technical arguments concerning affirmative fair housing duties, housing quality standards, and compliance with foreclosure procedures, and recast them in human terms. When a disabled Vietnam veteran, an elderly couple, or working parents spoke of their struggles to stop drug sales in the complex, the threats to their children, the need to protect a brain-damaged resident, or the basic sense of fair play in demanding that HUD clean up the mess it created in the community, they spoke in terms of values, images, and concerns that resonated with the local community.

By inserting a human dimension into the conflict, the residents blocked HUD's strategy to transform the struggle into bureaucratic haggling between professional advocates and HUD staff over interpretations of obscure regulations and technical processes. Instead, the residents enlisted strong local support that brought in the active intervention of both U.S. Senators.

Resident advocacy at the local level soon spread to the national level when the ERA enlisted the support of the National Alliance of HUD Tenants (NAHT). NAHT resident leaders brought the situation to the personal attention of then HUD Secretary Andrew Cuomo at a meeting between NAHT and HUD. Cuomo, in turn, personally made inquiries about the Ellison in a meeting with the director of the California Department of Housing and Community Development (HCD). From this chain of events, the Ellison gained support from both HCD and the California Tax Credit Allocation Committee. HCD was particularly helpful by extending the deadline for the HOME funds and committing additional funding to the project through the state Multifamily Housing Program.

Finally, with political pressure growing and a lawsuit imminent, HUD agreed to a foreclosure process that effectively transferred the property without cost to CHIP and also provided a \$1 million rehabilitation grant. Due to extensive rehabilitation that required relocation of the remaining residents and bureaucratic delays with the HUD grant, the preservation process was not completed until 2003. However, thanks to the determination of Ellison residents, the 94 units of the Ellison Apartments – now renamed Brickyard Creek – have been transformed from a source of physical, environmental, and social blight to an important resource for the community.

These benefits have been outlined in a recent 'best practices' guidebook on affordable housing and smart growth that features Brickyard Creek and is available for download at www.calruralhousing.org. A resident advocacy presentation, based on the Ellison and other resident initiatives, is also available on the same site.

Iowa: Working to Reverse Declining Rural Housing Markets

by Kate Ridge¹

Populations are declining in many parts of the Midwest where National Affordable Housing Foundation (NAHF) works, and affordable rental housing is often limited and in disrepair. Preservation of this housing is a tool that assists Midwestern communities to maintain and, when possible, to grow their economic viability.

NAHF is committed to partnering with local communities in its preservation efforts. Working with the Iowa USDA Rural Development housing office, NAHF has acquired nine RD Section 515 family and senior properties since 2005. These properties were at risk of being sold as market-rate housing, creating the potential for loss of affordable housing for working families and seniors. All told, NAHF now owns and manages about 700 units.

Approximately 70 percent of NAHF's tenants are elderly. Many of them are women coming off farms and delighted to be able to talk easily with their neighbors. Through its trained site managers, NAHF works to create a sense of community in each of its developments. Each development also includes services such as grocery delivery, information, and referrals.

NAHF recognizes that the need for affordable housing is particularly critical for seniors, but availability of appropriate housing is often extremely limited in rural communities. We believe that, with a commitment to our affordable housing mission and partnerships with others, the decline in rural housing can be reversed. The outcome will be stronger communities and improved quality of life for our most valuable community resources: residents.

Minnesota: Clover Patch Apartments: A Case Study In Successful Rural Preservation

Originally printed in the National Housing Trust's Preservation Newsletter, May 23, 2006

Despite challenges, affordable rural housing is being preserved. Clover Patch Apartments in St. Charles, Minnesota, a Section 515 property saved from market-rate conversion, is a case in point.

Clover Patch was transferred to a nonprofit after the owner decided to prepay the mortgage. But the deal almost did not take place; it was quite a challenge for USDA Rural Development to find a nonprofit willing to take ownership.

Clover Patch was eventually saved because a local nonprofit, Three Rivers Community Action, and the Minnesota Housing Finance Agency developed a successful strategy to raise sufficient rehabilitation funds and overcome the financial obstacles. But the difficulties Three Rivers encountered in saving Clover Patch underscore the challenges of revitalizing Section 515 properties and the need to make saving rural housing much easier, simpler, and more rewarding.

Clover Patch Apartments, built in 1980, was financed through USDA's Section 515 program. In 2001, the owner applied for prepayment. The 20-year low-income use restriction period imposed on post-1979 Section 515 properties had expired. As a result, the owner could convert

¹ Kate Ridge is President of the National Affordable Housing Foundation in Clive, Iowa.

the property to market rate, making Clover Patch’s tenants vulnerable to substantial rent increases.

After reviewing the owner’s application for prepayment, Rural Development determined the loss of this affordable housing would adversely affect housing opportunities for minorities in the region. This was significant because it meant the owner had to market the property to a nonprofit or public agency that would maintain affordability.

However, the search for a qualified purchaser was not easy, in part because nonprofits cannot currently be reimbursed for organization costs or earn a developer fee under Rural Development loan programs. Without the ability to earn a developer fee, only one group stepped up to the plate: Three Rivers Community Action. Three Rivers decided to divide the financing into two parts: Rural Development transferred the existing mortgage to Three Rivers and provided a new loan to cover the gap between the owner’s equity and the outstanding loan. Rural Development also increased the number of units receiving USDA project-based Rental Assistance from 18 to all of the property’s 32 units.

Three Rivers then found the funding for rehabilitation and organization costs to undertake the transaction. Minnesota Housing Finance Agency provided a \$350,000 deferred loan from its Preservation Affordable Rental Investment Fund Program, a statewide program that provides low-interest deferred loans to help cover the costs of preserving permanent affordable rental housing with long-term project-based federal subsidies that are in jeopardy of being converted to market-rate apartments. The Greater Minnesota Housing Fund provided a deferred loan in the amount of \$120,000. An additional \$50,000 contribution from First Homes, a local affordable housing foundation initiative, rounded out the financing mix.

Pennsylvania: MPR Tools Combine to Save Seniors’ Homes

by Laurence Anderson¹

Emerald Estates provides 35 one-bedroom units for seniors in rural Gallitzin, Pennsylvania, all with Rental Assistance. Built in 1981-82, the property was well maintained, but it became physically and functionally obsolete and began experiencing vacancy problems in 2001.

By 2006, the Estates needed immediate repairs costing \$313,000. A Capital Needs Assessment calculated that over 20 years it would require \$832,000. The owner, who remained in place, obtained \$35,000 from the state’s Affordable Housing Trust Fund and \$70,000 in new Low Income Housing Tax Credit equity, and provided \$5,000 from its own funds.

USDA Rural Development accepted the Estates for 2006 financing through RD’s Multi-Family Housing Preservation and Revitalization Restructuring (MPR) demonstration program. Three MPR tools were used:

- △ \$121,000 bullet loan (1 percent interest rate, interest and principal deferred, balloon payment due when the Section 515 loan is due);
- △ \$93,000 interest-free loan; and
- △ debt deferral of \$35,000/year for 20 years.

¹ Laurence Anderson is Assistant Deputy Administrator for Multi-Family Housing at USDA Rural Development.

As a result of the financial restructuring, the property's Section 515 debt service will decrease, its operating cash flow will increase, the apartments will be modernized, and vacancies are expected to decrease. Renovations included adding air conditioners and dishwashers in all units, replacing windows, replacing balcony and patio doors with doors that meet wheelchair accessibility requirements, and improving the fire alarms and smoke detectors in the common areas.

Virginia: Tax Credits and Tiers: Honeytree's Story

by Janaka Casper and Kathy Talley¹

Preservation of the Honeytree Apartments has been a sticky process for Community Housing Partners Corporation (CHP), an experienced nonprofit housing developer. CHP began its efforts in 2003 and was still facing unresolved issues in summer 2007.

The Honeytree complex is located in South Boston in south central Virginia, an economically depressed area of the state. Originally developed in the mid 1980s, Honeytree provides 48 apartments for families. In 2003, when CHP decided to purchase it, it was fully occupied and in reasonably good condition although it did need renovation. It had no USDA Rental Assistance, but CHP was able to move 21 units of RA to Honeytree from properties in other parts of the state.

Rent Structure

In March 2003, CHP signed an agreement to purchase Honeytree and applied for an allocation of Low Income Housing Tax Credits from the Virginia Housing Development Authority, the state's housing finance agency. In July 2003 CHP executed its LIHTC reservation agreement.

Like all tax credit developers, for Honeytree CHP had to balance its desires to serve families in the area, to make its tax credit application competitive by setting aside units for tenants with the lowest possible incomes, and to make the project feasible by bringing in the most possible rental income.

CHP chose to set aside five apartments for families with incomes at 40 percent of area median income (AMI), 35 for families at 50 percent of AMI, and eight for families at 60 percent of AMI. For each income level, there would be some one-bedroom units and some two-bedroom units. The rents would be structured accordingly; each unit size would have rent tiers corresponding to tenants' income levels, as shown in the table. Honeytree would be the first Section 515 property in the country with a tiered rent structure.

¹ Janaka Casper is President and CEO and Kathy Talley is Director of Multi-Family Housing Development Operations for Community Housing Partners Corporation, a nonprofit community development corporation dedicated to providing affordable housing and services for low- to moderate-wealth individuals and families. The John D. and Catherine T. MacArthur Foundation has helped to support CHP's preservation activities.

Tiered Rent Structure
Honeytree Apartments

Number of Bedrooms	Income Level	Number of Units	Rental Rates	Potential Income
1	40%	1	\$367	\$4,404
2	40%	4	\$441	\$21,168
1	50%	5	\$459	\$27,540
2	50%	30	\$539	\$194,040
1	60%	2	\$477	\$11,448
2	60%	6	\$539	\$38,808
Total		48		\$297,408

Acquisition and Obtaining Financing

Between July and December 2003 CHP focused on completing paperwork required by RD. Since that time, RD has simplified this process by creating a checklist of required items and posting its forms online. By November, CHP should have been ready to acquire the property in order to receive its allocation of the tax credits reserved in July. Since its RD paperwork was not yet complete, CHP asked VHDA for a two-month extension of the acquisition deadline. The agency provided CHP's tax credit allocation in December 2003 and extended the acquisition deadline. In January 2004, a second extension was needed. In February the purchase finally closed.

The December 2003 tax credit allocation established a critical deadline. Six months afterwards, by June 2004, CHP would have to meet the LIHTC program's "10 percent test" – that is, incur at least 10 percent of the project's basis – in order to keep the tax credits. Without them, this deal could not go forward. Furthermore, if CHP did not meet this requirement VHDA would bar it from using tax credits in the state for five years.

In practice, meeting the "10 percent test" requires the developer to spend at least 10 percent of the costs of acquisition or construction (excluding soft costs). For Honeytree, like for most acquisition/rehabilitation projects, acquiring the property meant the 10 percent test was met. CHP staff were relieved and encouraged.

Additional funding was being lined up around this time. In October 2003, VHDA committed to make a \$130,000 loan. By September 2004, CHP received funding commitments from the Virginia Foundation for Housing Preservation, an affordable housing lender that has since merged with Virginia Community Capital, and NeighborWorks® America. (These funds are included in the "other" line in the table showing sources and uses of funds.)

In fall 2004 CHP also applied for a subsequent Section 515 loan from RD to cover the cost of unanticipated construction required by RD and VHDA architects and inspectors including, for example, additional modifications for accessibility. In October 2005 RD made the commitment for this loan.

In January 2005, the tax credit equity and the construction loan closed. CHP began construction facing another LIHTC deadline: the property was required to be placed in service by December

2005, two years after the tax credit allocation. By December, CHP had spent at least \$3,000 per unit, the threshold for Honeytree to be considered placed in service, and met the deadline. Construction was not actually finished by that time, however.

One construction delay occurred because the original plan called for replacing part of the HVAC systems, but VHDA wanted the full systems replaced. When CHP acquired it, the property had a replacement reserve of \$144,000, so CHP wanted to use part of those funds to cover the HVAC costs. To obtain the necessary RD approval, CHP began discussing this with the agency in May 2005. The request was approved in October 2006.

Sources and Uses of Funds
Honeytree Apartments

Sources	
Virginia Housing Fund	\$130,000
RD #1: Original Loan	\$1,318,563
RD #2: Subsequent Loan	\$465,000
Other	\$214,000
Replacement Reserve	\$100,000
Tax Credit Equity	\$980,000
Deferred Developer Fee	\$217,033
Total	\$3,424,596

Uses	
Hard Costs	\$1,216,526
Soft Costs	\$489,372
Developer Fee	\$303,000
Acquisition Cost	\$1,415,698
Total	\$3,424,596

Steps Towards Rent Tiers

In October 2005 CHP submitted fiscal year 2006 budgets for all 18 of its RD-financed properties, including Honeytree, to RD for approval. The organization wanted to use tiered rents at most of these properties, but needed to get the concept approved for Honeytree first. The budgets without tiered rents were approved, but Honeytree's was not.

CHP staff had discussed the tiered rent concept with RD's state office early in the development process, and had received approval from the state multifamily housing director. Eventually, however, one of the four RD area offices in the state also became involved in the decision. Virginia's RD staff is structured so that the area director and the state multifamily housing director are peers, and the area staff did not favor the tiered rent idea.

RD's national office approved the tiered rent concept in February 2006, but that approval had not yet been implemented as of summer 2007. In April 2006, CHP submitted its 2007 budgets with tiered rents for all its properties including Honeytree. In October 2006, CHP submitted 2007 budgets with tiered rents for all of its RD properties.

Construction at Honeytree moved forward in 2006, with RD's final inspection in May, a follow-up inspection in July, and final RD approval in August after RD's punch list was completed. From September 2006 through March 2007 CHP staff met repeatedly with RD state and area office staff regarding several issues, resolving some but not all of them:

- △ tiered rents;
- △ RD's requirement that soft loans be repaid from the return-to-owner amount shown in the project budget;
- △ the value of the equity and CHP's deferred developer's fee that would be used to calculate the return to owner;
- △ differences between the vacancy and contingency rates required for the tax credit syndicator's project budget and those required by RD; and
- △ guidance on meeting other RD requirements for the project's budget.

In March 2007, CHP closed on the RD subsequent loan and the other permanent financing from VHDA and VFHP.

2007 Issues

By early summer 2007, three issues remained unresolved.

- △ If construction had been completed at the end of 2005, the permanent financing would have closed in March 2006. Because the closing was delayed, CHP carried the construction loan longer than expected and incurred additional interest costs. RD agreed to include part of the additional costs in a second subsequent loan, but that closing had not yet happened.
- △ RD's previous state director of multifamily housing had approved a CHP Rental Assistance Fund sufficient to enable a "ramp-up" of the tenant portion of rents over five years to bring original residents' rents up to the higher rent levels required for the deal's finances to work. Then CHP was asked to create a rental assistance fund to provide permanent subsidies for original tenants who could not afford the new rent levels. Questions remained as to how to determine the sizing of such a rental assistance fund for the few tenants that were affected.
- △ RD had not yet approved 2007 budgets for any of CHP's 18 RD properties.

It is hard to say whether CHP would have chosen to preserve the Honeytree Apartments if we had known in 2003 what we know now. Certainly, if we could start this deal over again, we would have included the RD area office in our communications from the very beginning, rather than meeting initially with the state office only. We strongly recommend that other nonprofits seeking to preserve USDA properties work with all potentially relevant RD offices together from the start.

It is gratifying, despite the difficulties, to know that 48 families in South Boston, Virginia will have decent, affordable homes thanks to CHP. A smaller organization probably could not have taken the risks, spent the time, and incurred the expenses needed to bring Honeytree even this far.

This guide offers a number of possible best practices for preservation of affordable apartments financed under the Section 515 Rural Rental Housing program of the U.S. Department of Agriculture. It covers not only the background of the federal program and its preservation components, but also the role of state agencies and a number of case study descriptions of successful preservation transactions.

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