

Affordable Housing Institute

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Affordable Housing: Uses and Sources of Funds

Uses of funds		When building a financing plan, <i>start with uses first</i> : they are what determine if the property will be viable. Sources determine if it can be financed. Some properties are unfinanceable -- that is, what it costs to do them properly cannot be raised -- which is why they are not undertaken. It is a capital mistake to start by what can be financed (sources first, then uses) because then one never gets an unprejudiced chance to ask whether the property is viable.
Construction / acquisition	+ _____	In an acquisition, price is a negotiable commodity.
Renovation / rehab	+ _____	Can be subdivided into two categories: (a) necessary for physical soundness and habitability, and (b) cost-effective (pays for itself in higher rents or lower expenses). Cost-effective improvements increase up-front capital outlays but decrease downstream operating expenses and thus make properties initially more expensive but more robust over the long term. Always ask, what does it take to make the property compete effectively?
Transition costs	+ _____	Vacancy, turnover, and interest during construction/ repositioning.
Soft costs	+ _____	Fees to the folks who put the transaction together.
Capitalized reserves	+ _____	The property should have working capital at inception.
Contingency	+ _____	Inevitably, something will go wrong, so a contingency is not a luxury, it is a necessity. But <i>how big</i> a contingency is property-specific. And what happens to unspent contingency? Who should benefit from it?
Developer's compensation	+ _____	Profit is the price paid for competence and risk-taking.
Total uses of funds	= _____	<i>Usually worth expressing per-apartment as well as in aggregate amounts.</i>
Sources of funds		Sources are what the sponsor must secure so it can develop/ acquire the property.

Grants	+ _____	Inevitably these are scarce resources subject an allocation procedure, and inevitably they are hard to come by, with demand outstripping supply. As a result, grants almost always have complicated strings and are competed for.
Loans - soft debt	+ _____	<i>Soft debt</i> is nominally a loan, but has no mandatory payment schedule, and is instead payable only to the extent available (usually with a priority of some kind) out of cash flow or residuals. As such, it is less attractive than a grant, but often easier to secure, and conversely more attractive than hard debt, but harder to obtain (because it comes only from someone whose motivations are more than just economic).
Loans - hard debt	+ _____	<i>Hard debt</i> must be paid from operating funds, and if not paid can be foreclosed. Hard debt is readily available if (i) the lender expects to be paid back, and (ii) the interest rate is commensurate with the risk (that is, the chance of non-payment). As a result, hard debt runs from very squishy (not much security but a high nominal interest rate) to very credit-worthy (lowest interest rate because highest confidence of repayment). <i>Credit enhancement</i> is the process whereby a financially responsible intermediary guarantees payment so the lender need only evaluate the credit enhancer rather than the property itself; since risk is lower, interest rates drop as well, and that in turn means lower debt service and a more financeable property. For many years, FHA mortgage insurance has been the best multifamily credit enhancement available.
Equity	+ _____	Equity can be further subdivided into (i) <i>economic equity</i> , where investors hope for a cash return derived from cash flow (through operations) and residual value (sale/ refinancing proceeds), and (ii) <i>tax-incentivized equity</i> , where investor return is funded through the tax code and hence cash return required from the property is usually minimal.
Total sources of funds	= _____	
Deficiency or surplus (Uses minus Sources)	= _____	If uses exceed sources, the financing plan is not viable - so the sponsor must try again, preferably by finding ways to increase sources rather than cut uses.