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# Chapter 7

## Valuation Analysis & Market Study Guidance

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### 7.1 Introduction

- A. This chapter provides guidance on HUD's Valuation and Market Study requirements for Third-Party MAP Appraisers and Market Analysis, MAP Lenders and Underwriters, and HUD staff involved in reviewing appraisals.
- B. The Valuation Analysis evaluates the existing or proposed project as collateral and security for a long-term mortgage. Depending on program requirements, this includes an estimation of the market value of the land and/or the property and an analysis of the market need, location, residential and commercial rent and other income, and operating expenses of the project.
- C. The Valuation Analysis develops conclusions with respect to feasibility, suitability of improvements, extent, quality, and duration of earning capacity and other factors that have a bearing on the economic soundness of the project. The objective of the appraisal and market study, if applicable, is to establish value for use in underwriting the supportable loan amount and to determine if the project will meet the market demand at rents that will pay operating expenses, debt service and provide for sufficient deposits to any reserve accounts.
- D. The Department has statutory authority (12 USC 1708(g)) to prescribe standards for the appraisal of all projects to be insured by the Federal Housing Administration. Such appraisals shall be performed in accordance with uniform standards, by individuals who have demonstrated competence and whose professional conduct is subject to effective supervision. Under the MAP Program, HUD relies on the MAP Approved Lender to provide such supervision through the underwriting, loan approval, quality control, and compliance program and protocols. Additionally, the Department requires a USPAP-Compliant appraisal review by a HUD Review Appraiser (HRA) for medium to high risk transactions.
- E. .The Multifamily Regional Center Director has authority to rely on the lender's appraisal review without a HUD staff appraiser review. Exercise of such authority may be appropriate for low-risk (minimal Level 1 repairs or alterations) and some medium-risk transactions) in which the application is complete, reliable and not particularly complicated. In all cases, a

qualified HUD employee must review each appraisal for compliance with USPAP and HUD requirements.

1. Low Risk Transactions – For example, most Section 223(f) projects with minimal (Level 1 or less) repairs or alterations.
2. Medium Risk Transactions – For example, 223(f) projects where significant repairs may be required, RAD or Tax Credit projects as well as Substantial Rehabilitation projects where there is minimal tenant displacement. This does not include projects that meet the criteria for large loan underwriting. New Construction projects may be included where the lender’s underwriter is experienced, and the market is well established.
3. High Risk Transactions – For example, most New Construction Projects and projects that meet large loan underwriting criteria set forth in Section 3.10. Also includes transactions with leasehold (versus fee simple) ownership interests.

## **7.2 Selection of Appraisers and Market Analysts**

- A. The lender is responsible for the selection and approval of appraisers and market analysts who are familiar with MAP guidelines. Lenders must ensure that each appraiser and market analyst selected is qualified to appraise or perform market analyses for multifamily properties by reviewing their education, quality, and frequency of multifamily appraisal experience, sample appraisals and market studies, professional affiliations, and state licenses or certifications. The ability to complete various HUD forms related to the appraisal, e.g. HUD-92264, 92273, 92274 etc., is also a requirement. The lender may assist the appraiser in the preparation of these forms, but the appraiser must sign them. The HUD 92264-A is an underwriting form prepared by the MAP Lender’s underwriter and is not a required appraisal exhibit.
- B. The appraiser or the market analyst must be independent of and may not be affiliated with the loan originator, broker, developer, borrower, MAP Lender or any individual or institution involved in any other financial role in the application. The underwriter shall not act as the appraiser or market analyst.
- C. The MAP Lender’s responsibility for supervision of the appraisal and market study (and any other third party reports) requires that the third-party appraiser be selected by the MAP Lender’s underwriter. The appraisal must be ordered and paid for by the MAP Lender and not by the originator, broker, developer or borrower. The appraisal must identify HUD as an intended user of the report. Appraisals prepared by any entity not engaged and paid for by the lender are not acceptable and will not meet HUD’s appraisal requirements.
- D. The market study should be ordered and paid for by the lender. However, a market study that

has been prepared for the borrower by a third-party market analyst and meets all other market study requirements of the Guide, including timeliness, is acceptable. The lender is responsible for the review and acceptance of all market studies submitted with the application.

- E. In accordance with the Fair Housing Act, there shall be no discrimination on the basis of race, color, national origin, religion, sex, disability, or familial status in the selection of an appraiser or market analyst. Discrimination by age is also prohibited by the Age Discrimination Act of 1975. The Equal Access Rule (24 CFR 5.105(a)(2)) provides for non-discrimination based upon actual or perceived sexual orientation, gender identity or marital status.
- F. HUD reserves the right to examine the credentials of all appraisers and market analysts hired by the lender, and to reject any individuals that it considers unqualified. HUD staff with concerns about a third party's capability, competence or experience should contact the Multifamily Asset Counterparty Oversight Division (MACOD) through their supervisory chain. HUD does not formally approve appraisers or appraisal firms as being "MAP Approved." Rather, the MAP Lender is responsible for ensuring the professionalism and competence of its contracted appraiser and the quality of the ultimate appraisal product submitted as a component of the lender's application.

Note: HUD will not reject any third-party contractor without having first issued warning letters to the lender highlighting the areas of non-compliance in their submitted reports. Third-party contractors will be afforded the right of appeal and due process in defending their work, consistent with MACOD procedures.

- G. The most current appraiser Certification required by Uniform Standards of Professional Appraisal Practice (USPAP) must be signed by the appraiser. In addition, the appraiser must include a certification that the racial/ethnic composition of the neighborhood surrounding the project in no way affected the appraisal determination.

### **7.3 Third Party Appraiser and Market Analyst Qualifications**

#### **A. Appraiser Qualifications**

- 1. Each appraiser must meet the following minimum qualification requirements:
  - a. Be a Certified General Appraiser under the appraiser certification requirements of the state in which the subject project is located;
  - b. Be currently active and regularly engaged in the appraisal of multifamily properties;
  - c. Meet all requirements of the Competency Rule described in USPAP, which applies to each certified appraiser who signs the report. If any of the persons involved in

preparing the report is a trainee acting as an assistant, this must be disclosed in the report;

- d. Have at least three years of income project appraisal experience;
  - e. Be knowledgeable concerning current real estate market conditions and financing trends in the geographic market area where the subject project is located, and be experienced in appraising multifamily properties with the complexity and characteristics similar to those of the subject project. If the subject contains commercial space, Low Income Housing Tax Credit (LIHTC) or other subsidies, the appraiser must have acceptable prior experience in the appraisal of comparable properties.
2. These requirements apply to each Certified General Appraiser signing the report. It is not permissible for an appraiser who is not certified in the appropriate jurisdiction to circumvent certification requirements by having a locally certified appraiser co-sign the report. Appraisers who are not certified in the appropriate jurisdiction may not perform the required project inspections of the subject or comparable properties. The appraiser must disclose any of the persons involved in preparing the report who are not certified general appraisers and are acting as an analyst, assistant or trainee.
  3. Temporary Certification. Temporary certifications are permissible; however, the above competency requirements still apply. The appraiser is responsible for checking the accuracy of all information obtained from local sources and must indicate the names of all individuals who provided material assistance in preparing the appraisal. A temporary certification must be obtained prior to beginning the assignment. The lender may select appraisers with a have temporary certification who have documented how they will achieve competence in the subject area in accordance with USPAP.

## **B. Market Analyst Qualifications**

1. Each Market Analyst must meet the following minimum qualification requirements:
  - a. Have at least 3 years of experience in performing market studies for income-producing properties,
  - b. Be currently active and regularly engaged in performing market studies for multifamily properties,
  - c. Be knowledgeable concerning real estate market conditions and financing trends in the geographic market area where the project is located, and
  - d. Be experienced in performing market studies for multifamily properties with the complexity and characteristics similar to those of the subject project. If the subject contains commercial space, LIHTC or other subsidies, the market analyst must have

acceptable prior experience with comparable properties.

2. MACOD will investigate any Regional Center or Satellite Office complaints that a lender is contracting unqualified or unlicensed appraisers or market analysts.

## **7.4 Valuation Reviews of Appraisal and Market Study Reports**

- A. Certain underwriting functions may be transferred to HUD staff who are in locations that are distant from the project under review. These functions may include, but are not limited to, HUD's review of the appraisal and market study.
- B. Third Party Appraisers and Market Analysts working on MAP transactions should assume that HUD staff that are performing reviews may not always be able to physically inspect the subject and comparables, and the market information used to verify and determine the validity of conclusions may be from nationally purchased data sources such as, but not limited to CoStar and REIS. (Note: In all cases the project will be physically inspected by a qualified HUD staff member for purposes of an environmental review.)
- C. Project locations that are outside the urbanized areas covered by these sources are affected by market forces for which there will be little property specific information available to HUD staff. HUD staff will not typically have the same level of knowledge of a particular project or location as the professional who has done the extensive research and analysis necessary to develop credible conclusions. The review function would not be efficient or sensible if it involved the same level of time required to develop and prepare an appraisal report/study. However, reviewers must take the time needed to make contacts with market participants to develop as much knowledge as possible to reach reliable conclusions about the work under review.
- D. Third party report providers and MAP underwriters must ensure the application and supporting material contain sufficient information for remotely located HUD staff to make an informed decision. For projects that are in a location that are not adequately covered by national sources, the reports must reference the local sources and contrast them with recognized national sources. The goal is to assure that the reviewer can fully understand the nuances of the local market.

## **7.5 Content and Format of the Market Study**

A. Purpose and Focus of the Study. The purpose of the market study is to assure that there is enough sustainable demand for additional units without adversely impacting the existing supply, so as to maintain a balanced overall market. The focus of the market study is on the overall demand within a defined market area, and of the proposed project's ability to capture and sustain a share of the total (incremental demand). The primary and secondary market areas analyzed by the lender's market analyst may be narrower in scope than the market analysis prepared by the HUD Economic and Market Analysis Division (EMAD), which analyzes the broader Metropolitan Statistical Area (MSA), county, or smaller submarket area as appropriate. The market analyst must, however, also discuss the larger MSA or county. The study must estimate the number of renter households with sufficient incomes to afford the type of housing at the rents proposed at present, as well as any expected changes in rental housing demand in the foreseeable future (typically the next 3 to 5 years). The study must also identify and discuss any risks associated with longer-term changes in rental housing demand (during the term of the mortgage). In addition, the study must estimate the number of units that the market could reasonably absorb over a specified forecast period, which is typically 3 years, taking into consideration competitive units in the existing inventory, units currently under construction, and units in the planning pipeline, as well as the gross and contract rents of those units.

For projects designed for the elderly, families, and persons aged 62 and over, the study must define the age restrictions, the anticipated household configuration and any anticipated household services. The study must also estimate the number of elderly households with sufficient incomes to afford the type of housing and services (if any) under study, any expected change in the number of such households, the proportion of those households that would need and demand such housing, and the number of units that the market could reasonably absorb and sustain over the forecast period.

The market study and appraisal should be completed by two separate entities in order to preserve independent analysis and conclusions. Any alternative such as two individuals from the same firm completing separate reports must be documented/supported by the MAP lender and approved by HUD at the concept meeting and documented in the encouragement letter issued by HUD. No market study, other than that which would be provided in the appraisal, is required for projects with 90% or more project-based rental assistance.

B. Effective Date. The effective date of completion of the market study for purposes of a pre-application submission must be within 120 days prior to the submission of the pre-application package. The date for submission of the market study for a firm commitment application must be within 180 days prior to the issuance of the Firm Commitment. The date of the market study can be the date of the site inspection or the date the analyst completes his/her research on active and proposed competitive properties (the effective date), but not to exceed 30 days from the date of the site inspection in either case (these dates should be noted by the analyst in the market study). The effective date is defined as the date that the opinion applies, , and may or may not be the same as the date of inspection. Expired reports must be updated as necessary by analyzing all relevant data. In cases where a Firm Commitment is delayed and the market has remained stable, HUD may, at its discretion, consider waivers to allow the lender's underwriter to resurvey the

data and provide an update letter referencing any changes or impact to the conclusion contained in the report.

The lender must either submit an updated market study or a Limited Scope Update to the original market study with the submission of the firm commitment application, assuming a two-stage application process. A Limited Scope Update report requires revisiting the demographic and competitive environment (including supply), a recalculation of Net Demand and Effective Demand, and a discussion of subject property's proposed rents in the current competitive environment. It should also include any material changes in the primary market area including unemployment rates, adjustments to the labor force, and any large layoffs or employment losses that may have occurred since the original market study. It does not require updating all contextual information included in the original market study and can typically be conducted as a desktop analysis.

C. Forecast Period for Market Study: The Forecast period for the Net Demand Analysis should be a three-year period starting at the effective date. Extenuating circumstances may require construction and lease up to stretch to a fourth year due to the regulatory environment or the nature of construction in the subject market (e.g. dense markets, high rises in central business districts). If the demand period exceeds three years, demand should be adjusted to match the specific term of the Forecast period. The longer demand periods must include an estimate of new supply beyond three years.

D. Project Rents Used in Market Study. The lender should compare the rents as determined by the appraisal to those concluded in the final market study. Variations in rents between the market analyst and appraiser may only have a minor impact on effective demand indicators, but may have a significant impact on the market analyst's opinion on absorption, since absorption is contingent on a specific rent level; the impact of which must be reflected in the final report. The market analyst must evaluate the rents for the subject and discuss the appropriateness of the rents based on current market conditions and an evaluation of the subject site and product offered, including suggested changes. Rents analyzed in the market study must be compared with the independent analysis completed by the appraiser and reconciled by the lender.

E. HUD as an Intended User. All studies should designate HUD as an intended user, along with lender and sponsor/developer.

F. Executive Summary. All market studies must contain an Executive Summary with a concise summary of the data, analyses and conclusions, including the following:

1. a description of the site and the immediate surrounding area;
2. a summary of the project, including the proposed targeted population;
3. summary statements describing the condition of the economic, demographic and competitive environment;

4. a statement of key conclusions reached by the analyst; including but not limited to the Net Demand and Effective Demand for the subject, and forecast average annual change in the number of households for a specified period of time;
5. a summary of competitive advantages and disadvantages, and issues that will affect the project's marketability, performance and lease-up, as well as points that will mitigate or reduce any negative attributes;
6. The number of units currently under construction in the development pipeline;
7. a statement of the analyst's opinion of market feasibility of the project; and
8. recommendations and/or suggested modifications to the proposed project, if appropriate.

G. Description of the Proposed Project. The market study must include a thorough description of the proposed project, including:

1. The number of units by type and size with information on the number of bedrooms and bathrooms, structure type, square footage, etc. Actual (paint to paint) size should be noted as well as the size in published brochures or other media.
2. The proposed contract, utility allowance and resulting gross rents by unit type. (Gross rent is defined as the cost of renting the unit, including the cost of resident paid utilities.)
3. Description of any income or rent restrictions imposed on the project by the use of public financing and/or subsidies (e.g., LIHTC, tax-exempt bonds or subordinate loans). Identify any project-based rental subsidies to be offered, specify the number of subsidized units, the type and form of the assistance, and rent levels related to market rents.
4. Utility policy in terms of which costs are paid by the tenant and which costs are paid by the owner/landlord.
5. The unit features, project amenities and services and associated cost.
6. For rehabilitation projects provide:
  - a. Description of the proposed scope of rehabilitation including a breakdown of hard and soft costs, if available.
  - b. An estimate of total construction cost and cost per unit.



- c. Identification of the existing unit mix and rents including any existing housing subsidies. Current and proposed rents should be compared.
  - d. Current and historical (if available) occupancy information.
  - e. An analysis of the current rent roll (if available) to determine if existing tenants will remain income qualified and/or able to afford the proposed rents.
7. The project location in terms of:
- a. Characteristics of the neighborhood in relation to schools, transportation, shopping, employment centers, social and community services, etc., to include a study of the adequacy of the public facilities that will service the site. The report must include a map showing the site and important neighborhood facilities and amenities.
  - b. Any other locational considerations relevant to the market and marketability of the proposed project.
  - c. A conclusion concerning the suitability/appropriateness of the site for the proposed use.
8. Other Characteristics, if any, of the proposal that will have a specific bearing on its market prospects and overall marketability.

H. The Primary Market Area (PMA) is the geographic area in which units with similar characteristics, e.g., number of bedrooms and rents, are in equal competition. The location of the competing projects and where the majority of the residents will be derived from must be discussed. The size of the PMA for general occupancy rental housing can vary significantly depending on the extent and location of comparable and competitive products within a specific area and geography. In some cases, both a primary and secondary market area must be defined. When defining the boundary of a market area, the analyst should consider the locations of comparable and competitive rental developments (existing, under construction and developments in planning) and commuting times from employment. Data on place of work or residence, population from the Decennial Census, American Community Survey (ACS), private data services and local sources will aid in this determination.

The market area analysis must include the following:

- 1. A legible map of the PMA, showing delineated boundaries, location of the subject, major highways and thoroughfares, geographic features like rivers and lakes, and political divisions such as state lines and city limits. The map must have a title, bar scale, north arrow and legend.
- 2. A description of the geographic boundaries of the PMA and a justification for the

delineation, including a discussion of the location of competitive housing, relevant services and amenities and concentrations of employment opportunities.

I. Economic Context. The market study must include a thorough description of the current and forecast economic characteristics and conditions of the PMA, county, "micropolitan" or metropolitan area (whichever is applicable). The description is necessary to provide background and justification for the subsequent demographic analysis and estimates of demand for additional rental housing. A discussion of current economic conditions and employment characteristics must be discussed, including:

1. Identification of growth sectors in the economy and emerging trends, including a detailed discussion of the sectors in the economy that have a major impact on the local housing market, such as military facilities, colleges and universities, federal and state government, major employers or tourism.
2. A study of recent trends in employment, including unemployment statistics, new job creation or loss, with a detailed discussion of: Historical nonfarm and resident employment levels and changes;
3. Any anticipated changes in employment as a result of expected closings, openings, expansions or cutbacks by leading employers, with a particular emphasis on how this would affect the rental market during the forecast period, including any seasonal employment markets.
4. Information on the types of jobs being created and lost, including data on pay scales and how these wage levels relate to the affordability of the proposed rental units.
5. List of major employers in the PMA, the type of businesses and the number employed.
6. In relevant markets (such as resort areas), comment on the availability of affordable housing for employees of businesses and industries that draw from the PMA.
7. A forecast of employment for the specified forecast period and how this forecast supports demand for additional new rental housing.

J. Demographic Analysis. The market study must include a thorough description of the current and forecast demographic characteristics and conditions of the PMA and a comparison secondary market including a detailed explanation of all significant trends and changes.

1. Recent trends in population and household growth from the most recent decennial census, current estimates and growth projections over the next 5 years covering such subjects as population change, migration, net natural change, household growth or decline, changes

in the average household size.

2. For senior communities, current and projected senior household base with 55+ and/or 62+ householders.
3. A thorough discussion of past building trends in comparison to household trends.
4. Characteristics of the current household base, including family type, current and change in tenure, age distribution and household type and rent burden.
5. Current income characteristics of the population and income by tenure.
6. For senior communities, tenure breakdown, income characteristics and rent burden of senior households.

K. Current Housing Market Conditions. The market study must include a comprehensive description of the current conditions of the rental market in the PMA, and of the sales market, if relevant. This description should include a summary statement on the current condition of the overall rental market and of the rent levels in the market of comparable projects, looking at both market rate communities and affordable units/communities. If appropriate to analyze, subsidized communities in which tenants are not responsible for all rent being charged should be discussed separately from market/affordable communities.

The analyses should include the following:

1. An estimate of the current competitive rental inventory of professionally managed units in the PMA, with data on the number of units by structure type, number of bedrooms, rent levels, year built and location.
2. A thorough discussion of recent market trends analyzing the following:
  - a. Current vacancy levels and recent trends in occupancy/vacancy in existing rental projects. Occupancy levels should be reported for market rate as well as affordable communities, and/or age restricted communities, if applicable.
  - b. Absorption experience of recently completed rental developments, including estimates at a project level of per unit per month absorption rates, with particular emphasis on comparable and competitive projects that have entered the market within the past 24 months.
  - c. Current effective rents for comparable and competitive projects, reflecting incentives and utility policies. A discussion of rent trends in this inventory during the past 24 to 36 months. The description should identify any services included in base rents or offered at a premium. Where relevant, the report should include information on the extent of rent concessions or similar incentives, particularly in

projects in initial occupancy and must address the impact of concessions on rent levels and whether the quoted rents are overstated due to concessions or other factors.

- d. Estimated current overall rental vacancy rate and vacancy rate for units similar to those in the proposed project. Significant seasonal variations in vacancy rates, if applicable, should be discussed.
  - e. Discussion of any vacancy or absorption problems in the market, particularly in the segments of the market most relevant to the subject project.
  - f. The impact, if any, of the single family and condominium market conditions, including an analysis of the cost to rent versus to own, and the impact of foreclosures and of the shadow inventory of single family and condominium units.
3. The report must include a map showing locations of existing competing rental projects, projects currently under construction, and those in the planning and development process.
  4. If appropriate, analyze inventory, occupancy levels, and waiting list of deeply subsidized communities in the PMA.
  5. If appropriate in markets without a significant inventory of professionally managed rental units, provide an overview discussion of the scattered site rental market that might compete with the subject property, including type of structure, units available, and rents

L. Characteristics of Rental Units in the Pipeline, Under Construction and in Planning. The market study must include separate estimates of the numbers of rental units currently under construction and in the planning and development process likely to enter the housing market during the specified forecast period. These estimates should include all rental developments known, not solely those determined by the analyst to be comparable and competitive. The description of the pipeline activity should clearly identify any significant characteristics of specific developments with rent restrictions or rent limits such as LIHTC or age-restricted occupancy. The report should contain estimates of:

1. The number of projects currently under construction, the total number of units, the numbers by bedroom size (number of bedrooms) by rent range, structure type and amenities (if available).
2. The number of projects in planning stages that are likely to be developed, including but not limited to those with building permits or firm financial commitments,

including details on the number of units by bedroom size, rents, locations, and stage of development.

3. A list of LIHTC projects in or near the market area that are not yet placed in service, giving as much known detail as possible on estimated placed-in-service dates, unit mix and income levels to be served.
4. For senior proposals, a list of all existing and anticipated senior projects within or near the market area, including characteristics such as type of age-restriction (55+ or 62+), number of units by bedroom size, income restrictions (if applicable), location, rents, and any features, amenities, etc. included with the rents. For future projects, as much known detail as possible on estimated placed-in-service dates should be included.
5. A map locating all proposed communities.

#### M. Demand Estimate and Analysis.

1. Net Demand Analysis: The market study must include an estimate of future demand for the specified forecast period, typically 36 months. The estimate of demand must be based on a calculation of incremental demand (i.e. demand for additional new units) and must address the following factors:
  - a. Renter household growth during the forecast period.
  - b. Recent trends in tenure broken down by homeownership and rental that may increase/decrease the demand for rental units. (e.g. households shifting from renter to owner tenure).
  - c. Replacement of existing rental units lost from the inventory due to demolition, conversion, shifting of owner units into the rental market and by other means.
  - d. The effect of any current excess vacant supply, based on an estimate of the balanced market vacancy rate, which is typically assumed at five percent.
  - e. The study must reconcile the number of units in the proposed project with the demand estimate for the PMA, taking into consideration current housing market conditions, available vacancy, and forecast additions to the supply (planned and under construction).
  - f. Impact of Demand on Occupancy Levels. Analysts must comment on the potential impact of the net demand conclusion on future occupancy levels in the market by the end of the forecast period, especially if net demand indicates supply and demand are concluded to be out of balance.

2. Effective Demand: The estimate of "effective demand" is the pool of households with sufficient incomes and/or applicable household size that would be expected to demand such housing during the forecast period, including the income levels and rent- to-income ratio(s) assumed in the study. Evaluation of Effective Demand includes an analysis of Capture Rate and Penetration Rate:
  - a. Renter Capture Rate is defined as the percentage of qualified potential renter households in the PMA that the property must capture to fill the units and achieve stabilized occupancy. Qualified Renter Households is defined as households that meet any applicable age and household size restrictions and are within a limiting income eligible band such as LIHTC Income Limits and who have sufficient minimum income to pay the proposed rent without being rent overburdened. The Renter Capture Rate is calculated by dividing the total number of units at the property by the total number of renter households that meet the applicable age and any income band requirements.
  - b. Penetration Rate is defined as the percentage of Qualified Renter Households in the PMA that the property and similar existing and proposed competing properties must capture to fill all units and achieve stabilized occupancy. The Penetration Rate is calculated by dividing the total number of units in the competitive inventory (including the subject property, current competitive properties and proposed relevant competitive properties) by the total number of renter households that meet the applicable age and income band requirements.
  - c. For communities with subsidized units, sensitivity affordability and penetration rate analyses should be conducted both with and without project-based rental assistance.
  - d. The capture and penetration rate analysis must be completed for each unit type at the subject property.
1. The evaluation of Net Demand and Effective Demand should take into consideration:
  - a. The current and anticipated supply/demand conditions in the overall rental market;
  - b. The potential depth of the market of income-eligible households in comparison to the number of units at the proposed rents; and
  - c. The marketability of the proposed units considering the project's amenities, rents and location relative to comparable and competitive projects and other available housing options.

2. For LIHTC projects: Provide an estimate of demand, including capture and penetration rates, based on potential income-eligible residents. An income-eligible resident is one whose income does not exceed the maximum permitted by the affordability restrictions but who has sufficient minimum income to pay the proposed rent without being excessively rent-burdened. Note: households are considered "rent-burdened" if they are paying more than 30 percent of their household income in gross rent ("severely rent-burdened" if they pay more than 50 percent). The market study must describe what basis is used for rent-burdened: e.g., 30 percent, or some other percent, but in all cases less than 50 percent. To make these determinations, consider the following information and guidance:
  - a. The market study should specify the applicable LIHTC maximum rents, market rents, and impact on achievable rents and project-based subsidy rents.
  - b. When the proposed rents are set at the LIHTC maximums, the market of income qualified residents for the restricted units is comprised of a relatively narrow band of income-eligible renters whose incomes do not exceed the maximum but are sufficiently high to pay the rent without being rent-burdened. This can result in problems with the market feasibility of the project. Depending on income and rental market conditions in the area, there may not be a sufficient number of potential renters who meet the income limit and are also able to afford the restricted rent. In many markets, LIHTC project rents need to be set below the maximum permitted.
  - c. Some LIHTC projects include additional types of assistance (such as Section 8 rental assistance or various forms of subordinate financing) which further reduce the tenant paid rents and thus expand the pool of potential income-eligible residents. The market study must identify the estimated number of households who are eligible but are not excessively rent-burdened when paying gross rent (including utilities).
  - d. The determination of demand and capture/penetration rates should take into consideration:
    - i. the current and anticipated supply/demand conditions in the overall rental market,
    - ii. the potential depth of the market of income-eligible households in comparison to the number of units at the proposed rents, and
    - iii. the marketability of the proposed units taking into account the project's amenities, rents and location relative to comparable and competitive projects and other available housing options.

The Regional Center/Satellite office staff should consult with EMAD in assessing the

determination of eligible income band, capture rate and absorption rate contained in the market study. Projects with insufficient demand for the units at the proposed rents should be rejected.

#### N. Findings and Conclusions.

1. Project Evaluation: Evaluate the subject property within the context of the site, economic, demographic and competitive characteristics. Comment on the strengths and weaknesses of the proposed project in terms of location, project size, unit breakdown, unit sizes, amenities, features and rents.
- 2.—The absorption rate is defined as a projection of the pace of unit lease up as units become available for occupancy. The study should also include an estimate of the absorption period needed for the project to reach a balanced market occupancy rate (e.g. 5% or market's typical stabilized occupancy level based on current market data and the *Net and Effective demand* estimates.
3. The market study must include an assessment of the impact the proposed project will have on existing rental developments. Specifically, the study must address the impact on existing insured properties and show if sufficient demand will be derived from new renter households, the shifting of households into the rental market, or the replacement of lost or sub-standard units. It must be demonstrated quantitatively that the number of units under construction and the proposed supply, including the subject, will not create over-supplied or overall soft market conditions. Even if the subject does not directly compete with existing insured or uninsured properties, an oversupply of units could spill over into all segments of the market.
4. For age restricted properties, the market analyst must describe the intended occupancy regime. The MAP Lender's underwriter narrative must ensure that the analysis and owner's intent based on their representations comply with FHA program guidance and Fair Housing law.
5. For Projects with a Commercial Component. The market analyst shall acknowledge and describe the presence of any commercial space. The description should include information on traffic counts, trends in commercial vacancy rates and commercial rents in the submarket in which the subject site is located, inventory of competitive centers in the immediate vicinity of the subject site, representative sample of rents presently available in the market, pipeline of commercial properties, evaluation of expenditures compared to supply to determine retail gaps in the market for retail, an opinion on commercial development opportunities on the subject site, and an opinion on achievable rent levels for such space. This level of detail is likely not necessary for commercial space under 5,000 square feet . A more detailed analysis will be completed by the MAP Appraiser. See 7.6.N.1



O. Additional Requirements/Guidance for Income Restricted Projects. According to USPAP Advisory Opinion 14:

“Subsidized housing may be defined as single- or multifamily residential real estate targeted for ownership or occupancy by low- or moderate-income households as a result of public programs and other financial tools that assist or subsidize the developer, purchaser, or resident in exchange for restrictions on use and occupancy.” While HUD provides the primary definition of income and asset eligibility standards for low- and moderate-income households, other federal, state and local agencies define income eligibility standards for specific programs and developments under their jurisdictions.

The competency required of appraisers and market analysts to appraise or prepare market studies for subsidized housing extends beyond typical multifamily residential experience and requires an understanding of the various programs and definitions involved in the particular subsidy program applicable to the development. Practitioners should be capable of analyzing the impact of a particular subsidy program in both the general market and the local subsidized housing submarket. Political changes may affect these requirements and therefore must be fully understood.

P. Data, Estimates, and Forecast. The study should document the methods and techniques used to develop all estimates and forecasts and provide relevant and current citations on the sources of all data, estimates and forecasts. Conclusions in the study must be consistent with the facts presented; findings and recommendations should be based on a reasonable forecast of market supply/demand conditions and sound assumptions regarding capture rates, absorption, achievable rents, income affordability and similar factors. To the extent possible, the qualitative and quantitative estimates of demand for additional rental units should take into account the changes in renter households by household size, not just in total. Although data for all household sizes may be used, a study of the trend of change by household size may derive a more representative and accurate demand estimate consistent with the characteristics of the target market.

## **7.6 Appraisal Requirements**

A. The Development of the appraisal must comply with USPAP Standards Rule 1, the Scope of Work Rule and assignment conditions outlined throughout this guidebook. The report shall be in a narrative format, comply with USPAP Standards Rule 2, and contain all of the information necessary for loan underwriting and for the reviewer to easily understand the reasoning employed by the appraiser. Standard Rule 2 does not dictate the form, format, or style of real property appraisal reports. The form, format, and style of a report are functions of the needs of the client and intended users. The substantive content of a report determines its compliance.

- B. **Effective Date.** For pre-applications, all appraisals must have an effective date within 120 calendar days before the date of the pre-application package. For Firm Commitments, the effective date of the appraisal must be within 180 calendar days prior to the issuance of the Firm Commitment. The MF Regional Center/Satellite Office may require an updated appraisal prior to an amendment, re-issuance or an extension of the Firm Commitment, e.g., if there is a material change in the terms of the mortgage or in the market conditions and market data upon which the Firm Commitment was based. Expired reports may be amended or updated as needed by re-surveying all relevant data. HUD defines the effective date as the most current date that the appraiser inspected the subject, and comparables and developed estimates of rents and expenses. Updated appraisals can be submitted if the appraiser re-inspects the exterior of the subject project, re-surveys the rental comparables, and reviews the market for any additional sales comparables. USPAP Advisory Opinion 3 should be followed for guidance on completing and reporting appraisal updates. Lenders should provide for updates in their response to the invitation letter in case of processing delays prior to issuance of the Firm Commitment. The Regional Center/Satellite Office has the authority to waive the 180-day requirement or decrease the amount of time until expiration of the report depending on market conditions.
- HUD recognizes that occasionally there may be situations where the Inspection Date and Effective Date may differ but there should not be a significant difference between the Inspection Date and the Effective Date. While in the course of preparing the appraisal report, new market information may become available that has a material effect on the results of the appraisal. This should be noted in the appraisal report. If there are questions, the Regional/Satellite Office (not HQ) should be consulted.
- C. **Brevity.** The appraisal report should be clear and concise. The appraiser should reference in the body of the report conclusions derived by the analysis of large tables of data and the actual data should be included as an addendum. Appraisals must be submitted as a searchable PDF file with one signed hard copy.
- D. **Complex or Unusual Appraisal Assignments.** When an appraisal assignment involves a subject with property rights issues or other unusual circumstances, third party appraisers must be sure to comply with USPAP Standards Rule 1-1(a), “In developing a real property appraisal, an appraiser must be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal.” When these issues occur, the lender and appraiser (if identified) should consult with the Regional Center/Satellite Office at a concept meeting before appraisal assignment begins.
- E. Form HUD-92264 and supporting forms HUD-92273, HUD-92274, and HUD-92264T (if applicable) must also be prepared and included in the report.

- F. The USPAP Jurisdictional Exception rule is not generally applicable in HUD appraisal assignments. Nevertheless, the USPAP Jurisdictional Exception Rule clearly states that if an applicable law precludes compliance with any part of USPAP, then that part of USPAP becomes void for that assignment, including administrative rules such as the MAP Guide and HUD Notices.
- G. Occupancy Percentage. Unless otherwise noted, the occupancy used in the valuation of properties for acquisition or refinance should be based on the occupancy that is prevalent for the subject's area. This is reflected in Criterion 3 on the form HUD 92264-A. The underwriters may need to use more conservative (lower occupancy/higher vacancy) rates to comply with FHA program guidance in sizing the debt-service constrained mortgage comparisons. The estimate of occupancy should take into account the historical performance of the subject and the vacancy and collection loss typical for the subject's market area to determine the occupancy percentage. The appraiser should ignore unsustainable market conditions and short-term spikes in the occupancy rate due to seasonal changes and short-term demand for specialized employment, e.g. disaster relief workers.
- H. Sections 220, 221(d), and 231 (new construction only) do not call for an "as complete" value conclusion. The Department considers valuation work for these assignments to be an appraisal that is developed and reported in compliance with USPAP Standards 1 and 2.
1. By statute, FHA Multifamily new construction programs are replacement cost-limited mortgages and require a valuation of the land, a debt service analysis and a cost approach to value. An estimate of the market value after completion is not required or relevant. The appraiser must fully examine the proposed construction costs of the subject project at the Firm Application stage. The MAP lender's Appraiser must present, analyze and support the cost approach based on the plans, specifications and development costs using either a subscription cost service, the lender's third-party cost analyst or a direct comparative analysis of recently completed similar developments. Substantial Rehabilitation projects require an estimate of the "As Is" value of the project (as opposed to only the land) by use of the income and direct sales comparison approaches to value when possible. Unoccupied or "shell" structures may be appraised using the sales comparison approach and/or cost approach.

**NOTE:** The Section 231 Sub Rehab Program is an exception – those projects require both a cost and "as completed" value limit mortgage.

For apartments that are occupied, the primary method to determining value is the Income Approach. The value should be what the typical purchaser would pay for the income stream currently associated with the subject based on its actual condition and occupancy restrictions. The as-is value must not be based on after rehab projected income or any advantages that will accrue as a part of the transaction.

**NOTE:** See special instructions for Cost Certification as it relates to As Is Valuation in Chapter 13.21.

2. Exhibits. The appraiser and the MAP Underwriter must assure that there is a sufficient narrative and exhibits to allow a reliable underwriting decision to be reached. This should include, but is not limited to, location maps, photographs of the subject, rent and expense comparables, site and floor plans, along with thorough explanations of all adjustments.
- 
- I. For Section 223(f), apply all three approaches to value for subjects that have an actual age of less than ten years. The appraisal for the 223(f) refinancing should assume market value for purposes of developing Criterion 3 and should further assume that any proposed repairs/improvements have been completed, as rents, expenses and value must reflect completion of any proposed repairs or improvements. Not all repairs/improvements will result in an increase in value. Structural repairs, utility line improvements or other repairs that do not directly result in an increase in market share or would not result in a resident's willingness to pay an increased rental amount will likely not increase value. Any proposed rental increase must be demonstrated by market data.

**NOTE:** The appraisal should use market value for purpose of developing Criterion 3 except in cases where rent control or a legislative restriction exists that limit the maximum rents in perpetuity and survive foreclosure. In these limited cases the affordable/legislatively limited rents should be used to develop Criterion 3.

1. Cost/ Summation Approach. The cost or summation approach must consider all applicable forms of depreciation, functional and external obsolescence. The cost/summation approach shall not automatically set the upper limit of value for these programs. The appraiser should provide a final reconciliation of the three approaches to value, and consider the basic principle of substitution in that no prudent purchaser would pay more for a project than the cost to acquire a similar site and construct improvements of equal desirability and utility. This approach may be eliminated at the discretion of the appraiser for subjects that are ten or more years old.
2. Sales Comparison Approach. In multifamily housing, the entire project as a whole typically does not offer a convenient basis for comparison with other entire projects due to differences in size, composition, areas, units and rooms. In such cases, acceptable units of comparison are price per living unit, price per room, and price per square foot of gross building area (GBA). Adjustments to the sales should reflect market conditions and be supported through appropriate analysis. A comparative adjustment for a Net

Operating Income (NOI) differential in the Sales Comparison Approach (more commonly known as an NOI adjustment) is not permitted under any circumstances.

3. Income Approach. The annual net operating income (NOI) remaining after the payment of expenses is considered to be the primary source of value to the project. The preferred method of capitalizing the NOI into a value estimate is Direct Capitalization. Note that the overall capitalization rate verified from Actual Sales is preferable to those used in the Sales Comparison Approach or developed by the Band of Investment Model or Investor Surveys, especially in the cases where rent restrictions are factored into Criterion 3 due to legislative restrictions on rent that survive foreclosure. There are several acceptable techniques for deriving capitalization rates. All of the following should be employed and thoroughly discussed:

A. Comparable Sales. Rate Extraction based on recent (preferably within the past year) comparable sales is the most preferred. Pending sales are also encouraged if reliable information is available. These must include ALL of the market comparables used in the Sales Comparison Approach or an explanation must be provided. Comparables should be similar to the subject in location, design, quality of construction, and similar risk factors associated with ownership. They should also be similar in the type of expenses, specifically noting variances in deposits to reserves for replacement.

B. Band of Investment Model. Band of Investment is based on the premise that most properties are purchased with a combination of debt and equity. The overall capitalization rate derived by this model must satisfy the market indicated requirements of both investment positions. Lenders anticipate obtaining a competitive interest rate commensurate with the perceived risk of the investment, and they expect that the loan principal be repaid through periodic payments. The property investors expect a competitive return through the equity capitalization rate commensurate with the perceived risk.

C. Published Surveys. These are to be discussed as supporting information.

- J. Reconciliation of the Approaches to Value. Reconciliation involves the data, analyses, and value indications from each of the approaches to value that were developed. It also includes the information comprising the appraisal problem and the underlying analyses of the apartment market, the property's location, and the property itself. All approaches must be internally consistent in order to achieve a reliable estimate of market value. The result of the

reconciliation should be a well-reasoned value opinion that discusses conflicting issues and inconsistencies that were revealed by the research conducted, and explains them, such that a logical and credible conclusion is reached.

- K. For Section 231 Substantial Rehabilitation cases, follow the instructions for Section 223(f). Substantial rehabilitation under Section 231 differs from Sections 220 and 221(d)(4) in that a market value based on the completion of the rehabilitation is required.
- L. Remaining Economic Life (REL). HUD Multifamily Housing programs allow for long term amortization periods. The HUD Underwriter must determine the REL and the remaining useful/physical life based on review and reconciliation of the appraisal, CNA, recommendations from the appraisal review, and their own observation. This estimate is not a strictly formulaic calculation. REL is defined as the estimated period during which improvements will continue to contribute to project value and an estimate of the number of years remaining in the economic life of the structure or structural components as of the date of the appraisal. For new construction and substantial rehabilitation projects, the maximum mortgage term is the lesser of 40 years, or 75 percent of the REL. For existing properties, the maximum mortgage term is the lesser of 35 years, or 75 percent of the REL.

When used in this section, the words and terms below are defined as follows:

1. Physical Life. The period from the time of completion (as new or after substantial rehabilitation) of a structure until it is no longer fit or safe for use or when maintaining the building in a safe, usable manner is no longer practicable. Because a building is subject to physical deterioration and obsolescence, its period of usefulness is limited. As a building deteriorates or becomes obsolete, its ability to serve useful purposes decreases and eventually ends. This may occur gradually or rapidly.
2. Economic Life. The period over which improvements to real property contribute to property value. Economic life can never be longer than the physical life, but may be shorter. Both Physical and Economic life will be affected by the underlying construction quality, market incentives, level of maintenance/updates to correct physical deterioration and/or functional obsolescence.
3. Functional Obsolescence. Reduction in the usefulness or desirability of the improvements to real property due to the presence of outmoded features such as lack of closet space or the number of bathrooms commensurate with the number of bedrooms. Such features are often not curable and may or may not be relevant in evaluating the REL.
4. Effective Age. The apparent age of the improvements to the real property, which may vary from its actual or chronological age. The effective age is determined by the appraiser assuming the required repairs to be made as specified in the CNA as a condition of refinancing and based on the following factors:
  - a. Workmanship, durability of construction and the rate with which natural forces cause

- physical deterioration;
- b. The physical condition and probable cost of maintenance and repair, the maintenance policy of owners and occupants and the use or abuse to which structures are subjected;
  - c. The economic background of the community or region and the need for accommodations of the type represented;
  - d. **NOTE:** Race, color, national origin, religion, sex, disability and familial status, which are all Fair Housing Act protected classes shall never be taken into account when conducting an appraisal.
  - e. The relationship between the property and the immediate environment, the architectural design, style and utility from a functional point of view and the likelihood of obsolescence as attributable to new inventions, new materials and changes in tastes;
  - f. The trends and rate of change of characteristics of the neighborhood and their effect on land values.
5. Remaining Economic Life (REL). REL is the Economic Life less the Effective Age. The effective age is determined by the appraiser based on the actual condition of the subject considering all applicable forms of depreciation. The appraiser should assume the required repairs to be made as specified in the CNA as a condition of refinancing and consider the type and quality of construction, maintenance factors, and any other relevant market and economic factors that might influence the long-term success of the project.

Examples that illustrate the implementation of these concepts:

***An older structure with functional obsolescence remains competitive in an area that is dominated by modern apartment projects commanding higher rents.***

Such structure could be a market rate project in a particularly desirable location, or a former public housing project. The MAP appraiser's market analysis indicates that there is a lower income population in the market area that will likely allow the project to remain competitive for a long term. This can cause the effective age to be lower, with a commensurate increase in REL.

***A structure that is sound and in good physical condition with many years of physical life remaining may have reached the end of its economic life - if its remaining years of physical usefulness will not be profitable.***

Apartment projects in a given market area have either been severely damaged or destroyed by a hurricane. Most of these properties are either being replaced by new structures or are receiving substantial renovation that will include correction of functional obsolescence. This could result in a lower effective age with a corresponding increase in

REL.

- M. HUD is the regulatory enforcement agency identified in the Confidentiality Rule of USPAP. Appraisers will be required to present their entire work file and fully disclose the identity and source of confidential information should the Department determine a review of the appraiser's work file is in order. (Note that, per USPAP, disclosure to enforcement agencies does not constitute a violation of the Confidentiality Rule.)
- N. Include an appraiser's Certification with the format in Section 11.2.G of the MAP Guide as well as the most current USPAP certification.
- O. Inspection of the Subject and Comparables. The primary appraiser designated by the lender and accepted by HUD must physically inspect the subject (both exterior and interior) and all of the comparables used as part of the analysis. The primary appraiser must also sign the Certification within the appraisal report and the supporting HUD forms.
- a. The primary appraiser must inspect at least one of each bedroom/unit type. The total number of units inspected must equal or exceed 5% of the total number of units for projects of up to 200-units, or 4% of the total number of units for projects greater than 200-units. If the characteristics and/or condition of the subject indicate that a higher level of inspection is necessary, it is the appraiser's responsibility to expand the scope of the work as may be necessitated by the observations made by the primary appraiser during the inspection of the subject. This is especially important where the improvements are high-rise structures and individual units within the building demonstrate varying degrees of light and view qualities. If there are hazardous conditions or other factors that preclude a thorough inspection of the interior, the appraiser must clearly indicate these circumstances in the appraisal report.
  - b. For large projects exceeding 500 units, the lender may permit a lesser percentage but reasonable number of units to be inspected by the appraiser. In addition, the appraiser may employ assistants to inspect individual units so as to encourage a thorough inspection. The names and qualifications of these assistants must be disclosed in the appraisal report. The assistants are not required to sign the report.
  - c. The primary appraiser must inspect all of the comparables used in deriving an estimate of value, including land comparables (if applicable), improved comparables sales, expense comparables and rental comparables. The appraiser must verify the condition of the



comparables with management or other personnel familiar with the project whose contact information must be documented in the appraisal report.

- P. Required Appraisal Report Exhibits. Photographs (subject, and all comparables including rentals), regional map, location map, satellite scans (if available from Google, Bing, etc.), flood hazard map, survey (if available), floor plans (for each type of unit being offered - if available), site plan, zoning map, tax map, land sales comparable map, rental comparable map, and improved sales comparable map are required with all submissions.
- Q. Market Analysis Requirements for Multifamily Appraisals. The appraisal must also contain, depending on the complexity of the project and prevailing market conditions, a Level B or C Market Analysis of the local market with an emphasis on multifamily housing to determine the ability of an existing project to continue usage as multifamily housing. In the case of proposed construction or substantial rehabilitation, the purpose is to determine overall feasibility and demand for new housing units. A brief outline of a Level C analysis follows:
- a. Location. This includes a general description, specific analyses of site linkages and urban growth determinants and detailed competitive location rating.
  - b. Demand Analysis. This includes a discussion of general evidence of sales/leasing activity, general city/area growth trends, market absorption, demand and need forecast based on population, employment and income and a demand forecast of the subject market segment.
  - c. Competitive Supply Analysis. This includes vacancy rates for comparables and from market surveys (secondary data), field research on all competitive and proposed properties, building permit analysis, identification of proposed sites, and a detailed competitive amenities rating.

The detailed requirements for performing a Level B or C analysis can be found in “Market Analysis for Real Estate”, published by the Appraisal Institute. In general, a stable market evidenced by a recent sales, and balanced supply and demand is an indication that a lower level “B” analysis will be sufficient. If there is uncertainty in determining the level of analysis, the lender and appraiser should jointly consult with the Regional Center or Satellite Office.

## **7.7 Estimating Project Income**

- A. Rental estimates. The appraiser must estimate the annual gross income of the subject project including estimates of income from market comparables, rental concessions, and an

assessment of the general health of the rental market. The gross income estimate assumes a full occupancy level and reflects rent levels current as of the appraisal date or date of the market study. Also, consider the effect that any proposed repairs to the project will have on rents, expenses, and net income; however not all repairs will increase rents, occupancy, net income, and/or decrease expenses.

Rent comparables. Market rent by comparison shall be estimated by the appraiser and documented on the Form HUD-92273 or Form HUD-92273-S8 if the appraisal is also being used as a Rent Comparability Study (RCS). A separate Form HUD-92273 is to be prepared for each type and size of rental unit in the subject project (if significantly different).

Market rents attributed to the subject property should not be speculative. If rents are based on levels achievable assuming that proposed repairs are completed, then those units that have had repairs completed and are leased are most reflective of market or near market rent levels. The rent comparables and units selected for comparison must be as similar as possible to the subject project and units as to location, structural type, number of bedrooms, and average unit size. In order to ensure they are truly comparable and competitive with the subject project, appraisers should generally not use rent comparables located outside of the subject's market area, but should be from areas similar to the subject and should be fully explained in the report. Market rate units from partially assisted projects can be used as rental comparables in the absence of better rental data.

- B.** Adjustments. Consistent adjustments for significant differences between the comparables and the subject units shall be derived from the market and applied to the subject rent estimate and fully explained. Rental adjustments are always made to the comparables reflecting differences with the subject project.
- C.** The appraiser should select the final rent estimate based on the comparables that are the most similar to the subject in location, size, style and desirability. In situations where the appraiser gives the greatest weight to the highest or lowest comparables, the appraiser must explain and substantiate with market data why the chosen comparables are the most reliable. Often the best comparables are those that require the least amount of adjustment. Just as the most appropriate rent comparable must receive more weight, the general health of the rental market must be recognized before relying upon one or two optimistic indicators.
- D.** On LIHTC and/or bond financed projects, the Form HUD-92264T must be completed to determine the appropriate processing rents.
- E.** Trending of Rents. Rental estimates shall be made as of the appraisal or market study date and may not be trended to a future date. Since rent estimates are made based on street rents currently being obtained by the comparables, no time adjustment is needed for an estimate as of the appraisal or market study date. Estimate GPI based on in-place rents at the subject property as evidenced by current rent rolls. However, rents may be adjusted based upon improvements to be made as part of the refinancing that will increase marketability.

- F. Equipment included in Rent.** Equipment included in the subject rent such as ranges, refrigerators, microwave ovens, air conditioning equipment and laundry facilities must be identified. Services included in the subject rent frequently include heat, air conditioning, water, and trash removal, and must also be identified. Comparable project equipment and services must correspond to the same items of equipment and services provided in the subject proposal and the adjustment process must reconcile any differences. This analysis also applies to the analysis of expenses.
- G. Occupancy/Vacancy and Collection Losses for Residential Units.** The appraiser must establish a factor for vacancy and collection loss when determining the effective gross annual income for the residential units. The factor must consider both historical and current data (applicable for existing properties) of the subject project, the rental comparables and any anticipated changes in the market. The factor selected must reflect long-term occupancy rates that are expected to continue. The estimate of occupancy should be based on the actual occupancy of the subject without regard to programmatic constraints imposed on the maximum underwritten occupancy when calculating debt service coverage. The estimate of occupancy must take into account the vacancy and collection (bad debt) loss typical for the subject’s market area and, if applicable, be consistent with the subject’s historical performance.

In most cases the appraiser should use income from actual operations and market conditions in determining value. In sizing the loan for purposes of debt service, the underwritten vacancy rates will be the greater of the minimums below and the vacancy loss rates for the subject property. However these minimums may be used to develop market value if deemed appropriate by the appraiser.

| <i><b>Minimum<br/>Vacancy<br/>and<br/>Collection<br/>Loss Rate</b></i> | <i><b>Property Type</b></i>   |
|--|---|
| 3%   | o Properties with HAP contracts covering 90% or more of the units   |
| 5%   | <ul style="list-style-type: none"> <li>• Properties meeting at least the minimum LIHTC set aside requirements (20% of the units set aside for tenants earning no more than 50% of median income; 40% of the units set aside for tenants earning no more than 60% of median income; or with income averaging, 40% of the units at an average income of no more than 60% of the area median income); <b>and</b></li> <li>• Attainable tax credit rents at a least 10% below <del>discount to</del> market.</li> </ul> |
| 7%   | <ul style="list-style-type: none"> <li>• LIHTC properties with any percentage of units set aside but without a 10% discount to market; <b>or</b></li> <li>• Other properties that do not meet the requirement for a 5% or 3%</li> </ul>   |

|  |                 |
|--|-----------------|
|  | minimum vacancy |
|--|-----------------|

- H. Project Rent Concessions.** Rent concessions in comparable projects must be included in the analysis and an appropriate adjustment made to the subject rent based on the comparable units. The adjustments must reflect the actual impact on gross annual income resulting from the comparable rental concession.
- I. Occupancy.** When the occupancy rate in a comparable project is significantly less than the long-term occupancy rate estimated for the subject, a downward adjustment should be made to the comparable’s rent. If other factors such as condition have an effect on occupancy, care should be taken to avoid excessive and duplicative adjustments for interdependent factors. The appraiser must note the actual market derived commercial vacancy/occupancy rate in the appraisal report. However, the appraised value of the commercial space component for acquisition/ refinance or the underwritten net operating income (NOI) for new construction/substantial rehabilitation projects must assume either the lesser of what is indicated by market or the occupancy limitations of the specific program.
- J. Utilities/Services.** All of the items for consideration under this heading refer to the cost of the services of water, sewer, gas and electricity that may be included in the rent. In some cases, even though both the subject and the comparable units have the same service included in the rent, an adjustment may still be warranted to bring the comparable in line with the subject, due to size, equipment, utility rate, type of utility, etc. If included in the comparable rent, but not in the subject, enter a negative adjustment reflecting that portion of the comparables rent attributable to the inclusion of the service. If excluded from the comparable rent, but included in the subject rent, enter a positive adjustment reflecting the estimated increase in rental value attributable to including the service in the subject’s rent.
- K. Project Location, Amenities and Other Factors** Consider the subject location relative to distance from shopping, recreational, social, medical and employment centers, neighborhood desirability, transportation, special hazards and nuisances.
1. “Other” items that may be considered include but are not limited to, the following:
    - a. Livability—reflect good or poor unit design and configuration, including room sizes, layout adequacy of closets, lighting, elevators and laundry facilities, etc.
    - b. Condition of improvements—reflect lack of maintenance, soundproofing, etc.
    - c. Parking—reflect parking rates, adequacy of parking for visitors, proximity of parking to the units, inclusion/exclusion of parking space with unit rental, etc.
    - d. Project density—consider open space or crowding of units, if the degree of either is such that it would affect the level of attainable rental.
    - e. Unit location—reflect features of location of a unit within the project, such as view,

proximity to swimming pool, tennis or other recreational facility, and/or other similar factors.

2. Generally, only high-rise elevator comparables are to be compared with the subject elevator high-rise proposal. Mid-floor level rents of the comparables are compared with the mid-floor level of the subject project. Rent adjustments for heights of the comparables above and below the mid-floor level of the subject also must be made, as indicated by the market.

#### **L. Other Income.**

1. **Ancillary Income.** The appraiser may consider other income based upon the operating history of the project only where these sources of income are common in the market. Other income might include but is not limited to recurring and reliable sources such as laundry facilities, parking, equipment rental, and vending machines. The appraiser may consider the net amount of this other income based on the actual (historical) amount received. Any projections of other income must be supported by market information and should not automatically assume a direct relationship to residential occupancy. This analysis must be discussed in the appraisal report
2. **Resale/Submetering of Utilities.** This type of income may be recognized so long as it is legally acceptable, is typical for the market and is transferable.
3. **Income from Re-sale of Internet and Media Services.** Income from the re-sale of internet and media services must be both legally acceptable and typical for the market. The MAP Appraiser and Underwriter must address the issue of competition with other service providers as well how this service is provided, specifically taking into account changing technology. Contracts between service providers must be assessed for risk due to factors such as transferability upon the sale of the project, long term financial strength of the service provider, the length of the contract and the upfront cost of procuring a contract. For 223(f) or existing 231 projects, there must be clear market-derived indications that having this service results in an increase in a project's value.
4. **Cell Tower Income.** This is a form of commercial income. Its inclusion in the estimate of value is discouraged unless there is an established long-term lease with a reliable lessee. If cell tower income is to be recognized for either underwriting or valuation purposes, the MAP Appraiser and MAP Underwriter should address the risk associated with present and future competition as well as technological changes, and a higher capitalization rate may be used if income is recognized for valuation purposes.
5. **Short-Term Lease Premiums.** Projects with lease terms that are less than 30 days are not eligible for HUD-insured financing under any circumstances, and should be distinguished

from Corporate Leases defined below. Income from other short-term leases may be considered to the extent that it exists in the local market. There must be a thorough discussion of the prevalence of short-term leases in both the appraisal and underwriting summary. The amount of the premium is the difference between the rent for a unit with a term that is typical for the market (generally one year) and the rent for a short-term lease. This premium is resident-related and is treated as ancillary income. Units with short term leases do not require a separate Form HUD-92273, but the rental amount must be based on market information.

6. Corporate Leases. Corporations and businesses are eligible residential residents in insured projects, so long as the lease term equals or exceeds 30 days although compliance with the policy on Short-Term Lease Premiums is required and the number of units subject to the leases does not exceed 10% of the units. For underwriting and valuation purposes, the percentage of total gross income obtained from corporate leases shall not exceed 10%. Requests to waive this guidance will rarely, if ever, be approved.
7. Pool, Pet Fees/Rent. These fees may be recognized based on operating history and prevailing market conditions. For existing projects (223(f) and occupied substantial rehabilitation) the greatest weight should be given to operating history. For new construction cases, any projected income from these fees must be supported by hard data and a thorough discussion of competing and comparable properties.
8. Ineligible Income. Ineligible income should be noted and discussed in both the narrative appraisal report and the remarks section of the Form HUD-92264. There is no prohibition on this category of income but it cannot be included in the income calculation for the purposes of determining value or the maximum insurable mortgage. Ineligible income includes the following:
  - a. Interest Income. The appraiser must not include in the calculation of income any interest income, including interest on reserves.
  - b. Ineligible Fee Income. Non-recurring and non-regular income that is not reliable may not be included in the calculation of income. Examples may include, but are not limited to forfeited security deposits or forfeited rent. Reliance on a forfeited security deposit or forfeited rent may be common due to management practices in a project or market, but will not be recognized by HUD/ FHA on either the valuation or underwriting.
  - c. Furnished Units. Furnished units must be underwritten at the same rental rate as unfurnished units. This applies to all units, including those having corporate and short-term leases. For valuation purposes, furnished units can be valued based on the prevailing market conditions.

d. Non-Shelter Services/Elderly Developments. Refer to Section 3.1.O.6.

9. Commercial Income. Where commercial facilities are included in a mixed-use project, a separate analysis must be made of the effect that the commercial operation will have on the project. The appraiser must calculate income, vacancy and collection loss, operating expenses, and replacement reserves attributable to commercial space separately from the residential space. Project paid resident improvements must be accounted for as a leasing expense, and if applicable, a separate commercial-space operating deficit must be calculated in addition to the required residential operating deficit.
10. The term "Commercial" is applied to any space or facility permitted and acceptable for "Nonresidential Use" from which income is derived or anticipated. Income from residents for the use of facilities such as community rooms and parking are not considered commercial even though fees may be collected. This income is considered ancillary income and is treated separately from commercial income. However, income from non-residents related to parking or other community facilities must be treated as commercial income and is subject to the restrictions on the underwritten occupancy rate as noted in Chapter 3.
11. The space occupied by parking and community facilities is not included in the calculation for allowable commercial space. Non-tenant parking income from commercial parking spaces reserved for use by motorists who are not project residents or are not parking to use the on-site commercial tenant's facilities must be included in the Commercial Space and Income limitations. The income and space attributable to parking spaces reserved for non-residential or non-commercial tenants must be included in the limitations, based on applying the percentage of the total spaces that are reserved for non-tenant use. For existing properties that provide parking for a monthly fee and are to be acquired, refinanced or will undergo substantial rehabilitation, the lender must identify the percentage of monthly parkers who are non-tenants so as to include these in the commercial income limitations. The maximum occupancy factor to be applied to the parking income attributable to parkers who are not associated with either the project's residential or commercial tenants shall be the lower of:
  - a. The amount indicated by the market and by the historic performance of the subject;  
or
  - b. 50 percent.

**NOTE:** For proposed construction, or where new commercial parking facilities are to be constructed, the demand for this parking must be addressed in the, appraisal and underwriter's narrative.

If the borrower operates a parking facility that provides parking for residential or commercial tenants of the project, the lender must determine underwritten parking

income based on an analysis of the past 3 years of operation and the trailing 12-month period prior to application.

If the parking facility is operated by a third-party, the lender may use the amount of income collected under the contract if it is a fixed monthly payment. Parking contracts that specify a percentage rent in addition to or in place of a fixed rent are not permitted without a waiver.

A separate analysis must be performed for each type of space using the Form HUD-92273 or a similar format to summarize appropriate adjustments to comparable data. These studies can be incorporated as a separate section in the overall residential market study submitted at the pre-application or firm stages, depending on the program requirements, and must also comply with Appendix 7A. Care must be taken in reviewing the allowable square footage and income percentage attributable to the commercial/office space since these requirements vary by program. See table below:

| <b>Commercial Space and Income Limitations</b> |  |   |
|--|--|---|
| <b>SOA</b>                                     | <b>Maximum Allowable Percentage of Total Net Rentable Area</b> | <b>Maximum Allowable Percentage of Effective Gross Income</b> |
| 221(d)(4) and 231                              | 25%  | 15%   |
| 220  | 25%  | 30%   |
| 223(f)   | 25%  | 20%   |

For all programs except Section 223(f), the maximum underwritten commercial occupancy rate shall be the lesser of: a) that indicated by the market, or b) 80 percent. For Section 223(f), the maximum underwritten commercial occupancy rate shall be the lesser of: a) that indicated by the market, b) the actual occupancy rate of the subject, or c) 90 percent. For special instructions related to the maximum underwritten occupancy rate for non-tenant parking income see Section 7.7.L.11

**M. Limited Waiver of Commercial Income and Space Limits.**

1. Commercial Income Limits. Regional Center Directors may issue waivers of the commercial income limits in Section III B, above, so long as the amount does not reflect a property that is primarily commercial rather than residential. New construction and substantial rehabilitation projects with commercial income greater than 20% of the



effective income should, if located in a Section 220 eligible location, use the Section 220 program rather than a waiver of the 221(d)(4) limit. The Regional Center Director's approval must document that the project's commercial component will contribute to meeting the Department's Strategic Plan Goals, including promoting sustainable communities or supporting transit-oriented development. If the lender requests a waiver of the commercial income limits, HUD may require that the request be supplemented by a complete credit analysis of all existing or pre-leased commercial tenants. Waivers may be granted where there are clear mitigating circumstances that justify such a waiver. Examples include but are not limited to:

- a. A long-term lease with a credit-worthy tenant, such as a government agency or a large, well-established corporation;
  - b. A multi-tenant commercial space where most of the tenants have a long history of occupancy (5 or more years) and full occupancy of this space is not needed to provide a break-even cash flow for the project; or
  - c. There is substantial borrower equity and/or local government funds that mitigate risk.
  - d. Existing Section 223(f) projects with an established history of commercial income exceeding the 20% limitation, but less than or equal to 30%.
2. Commercial Space Limits. Regional Center Directors may issue waivers to exceed the commercial space limits in Section III B, above. In order to justify a request to waive the commercial space limitation, the owner must demonstrate:
- a. that the additional space will not negatively impact on the use of the project by its residential tenants and will not create a nuisance to the surrounding community, so as to create a situation where the project is no longer residential in nature;
  - b. there is ample market support to assure occupancy of the space within the projected absorption period; and
  - c. any issues involving easements, liability insurance, parking and zoning must be resolved prior to granting the waiver.
- N. Unlike the valuation of the residential portion of a mixed-use project, the appraiser must value the commercial portion of the project, by applying the programmatic income and space limitations used to establish the commercial NOI for calculating debt service coverage (see Chapter 3).

1. The appraiser must: Conduct a complete analysis of at least three commercial income and expense comparables and provide a photograph, the resident's name, type and address of business, square feet, rent, vacancy, any concessions and major lease terms for each comparable.
2. Provide data to support the subject's commercial vacancy rate in relation to the market commercial vacancy rate and review the rollover risk and cost of resident improvements to re-lease space. Use a vacancy factor of not less than 10% for Section 223(f) and 20% for Section 221(d) and Section 220 new construction or substantial rehabilitation to obtain effective gross commercial income for underwriting purposes.
3. Provide the term, commencement date, expiration date, and name of the resident, square footage, and calculation of gross rents, expenses, reimbursement of expenses, cancellation clauses, and renewal clauses for each lease.
4. The project expense estimate must include all commercial expenses payable by the project owner. The analysis of all commercial income and expenses must be reflected on Form HUD-92264 with all the supporting data attached to the form. The expense estimate must include all commercial expenses payable by the owner.

## **7.8 Operating Expense Estimates and Underwritten Net Operating Income (NOI)**

- A. Purpose. The appraiser shall determine the costs to maintain, operate and repair the project and to defray the costs of ownership. An accurate analysis of operating expenses is essential to determining a realistic net income estimate.

Appraisers must use the Form HUD-92274, Operating Expense Analysis Worksheet, to develop project expense estimates to be included in Section E of Form HUD-92264, Project Income Analysis and Appraisal. Form HUD-92274 must be included in the processing file as supporting documentation for Form HUD-92264.

Market expenses attributed to the subject should not be speculative and should bear some reasonable relationship to the project operating history, understanding that some savings in operating expense line items may be gained when proposed repairs are completed. An example of savings might be reduced utility expenses based on the installation of certain energy-efficient features. Reduced real estate taxes based on a new assessment classification would also be justification for estimating operating expenses lower than indicated by the project-specific operating history.

## B. Sources of Expense Data.

1. For new construction projects, operating expenses must be estimated on the basis of comparable projects.
2. For existing projects, for both valuation and debt service, operating expenses must be adjusted on the basis of comparable projects, but will primarily be based on the past 3 years of operating experience for the subject project. In addition, the lenders should provide trailing 12 months of income and expenses for the appraiser to compare to the historical statements.

- a. The most current year project financial statement must have a third-party CPA or IPA review. Owner certified financial statements may be submitted for the years prior to the last full Fiscal Year. Any owner-certified financial statement or owner-certified balance sheet and operating statement must include the following acknowledgment:

“WARNING: 18 U.S.C. 1001 provides, among other things, that whoever knowingly and willingly makes or uses a document or writing containing any false, fictitious, or fraudulent statement or entry, in any matter within jurisdiction of any department or agency of the United States, shall be fined under that title or imprisoned for not more than five years, or both.”

- b. Exceptions. For refinance transactions where the project may not have been under the current ownership for the 3-year period, financial statements for the entire 3 years may not be available. This is particularly true for bankruptcies or the acquisition of defaulted properties. Also, in purchase transactions, not all the required information may be available for reasons beyond the purchaser’s control. In these situations:
  - i. The borrower must submit a statement through the lender that explains why all the required records cannot be obtained.
  - ii. The lender must also certify that they have evaluated the borrower’s statement and agree that the information is not available.

The Regional Center Director may waive the requirement for past 3-year period financial statements. However, the borrower must submit the project financial statements that are available including an owner-certified year-to-date balance sheet and operating statement.

3. All projects must be analyzed as independent operations and must not reflect shared expenses from nearby projects under the same management, including shared insurance premiums. If the nearby project should be subject to foreclosure, the subject project would be adversely affected, thereby constituting an unacceptable underwriting risk. For the same reason, estimated expenses must reflect typical long-term operation and must

not reflect a specific sponsor or management entity whose operation would not be typical.

C. General: Operating expenses are periodic expenses needed to maintain the project and to continue the production of effective gross income, and represent the totality of all expense items as recognized under Generally Accepted Accounting Principles (GAAP), except to the extent modified by HUD Program Obligations. Operating expenses must include the annual amounts deposited to the Reserve for Replacement. Operating expenses shall not include interest charges, or charges or allowances for depreciation of real or personal property, or amortization of financing expense, or payments to any officer or director of the corporation, unless such payments are for services which are necessary to the operation of the project. For appraisal purposes, an operating statement that conforms to the above definition of operating expenses may differ from statements prepared for accounting purposes. Current or historic statements must be prepared on a cash basis. It is important to verify the accounting basis for the operating statement, since project operating expenses for appraisal purposes must be reported on a cash basis. Typical categories of expenses are as follows:

1. Fixed Expenses. Fixed expenses are those that generally do not vary with occupancy and have to be paid regardless of whether the project is occupied or vacant, and generally do not fluctuate greatly from year to year. Real estate taxes and insurance costs are typically included as fixed expenses.
2. Variable Expenses. Variable expenses are operating expenses that vary with the level of occupancy or the intensity of project operation. Operating expenses for large properties frequently list many types of expense variables, but typical broad categories include the following:
  - a. Management charges
  - b. Utilities – electricity, gas, water, sewer charges
  - c. Heating and air conditioning (HVAC)
  - d. General payroll and security
  - e. Cleaning expenses
  - f. Maintenance and repairs
  - g. Decorating
  - h. Grounds maintenance
  - i. Exterminating
  - j. Trash removal
  - k. Miscellaneous (supplies, etc.).
3. Reserve for Replacements. This reserve category provides for the periodic replacement of the building components that wear out more rapidly than the building shell itself and must be replaced periodically during the building's economic life. These components may include but are not limited to roof covering, carpeting, plumbing fixtures, appliances

and HVAC. The estimate of the reserve for replacements should be based on reserves that are typically collected for comparable properties in the subject's market area, without regard to FHA programmatic requirements used for determining the required replacement reserves when calculating debt service coverage. The appraiser must document the research conducted to make this determination. The MAP lenders underwriting narrative must address any variance between the market reserve cost used on the appraisal and the FHA required deposits included in the underwriting.

4. Total Operating Expenses. Total operating expenses for residential properties are the sum of the fixed expenses and variable expenses updated to the appraisal date, plus the reserve for replacements.
5. Commercial Facilities. Where commercial facilities are included in the subject project, a separate analysis must be made to determine the effect that the commercial operation will have on the project expense estimate.

D. Estimate of operating expenses by units of comparison. Items of expense shown under each comparable and the expense items applicable to the subject proposal must be expressed as suitable unit of comparison—such as expense per unit per annum (PUPA), and expense per square foot of net rentable area per annum (PSFPA), or percent of effective gross income. The expense comparables and units selected must be as similar as possible to the subject project and units as they relate to the subject location, structural type, number of bedrooms, and average unit size.

For consistency purposes, expense components must be expressed in the same units of comparison so that the expenses for the subject proposal can be totaled. However, if the unit of comparison for a specific component is different from the basic unit of comparison for the other expense items, this different unit of comparison must be explained in the expense narrative. The dollar amount of the expense item can afterwards be converted to the same unit of comparison selected for the other expense components. Additional documentation must be submitted, as needed, for all component estimates that are not self-explanatory.

E. Expense Comparables. All insured HUD properties used as expense comparables must be identified and disclosed in the appraiser's Form HUD-92274, expense analysis and in the appraisal, except as noted below.

1. General Requirements. All comparables (confidential and disclosed) must be representative of the physical and location-specific characteristics of the subject project. Appraisers must always present the best comparables available for their analysis and must refrain from repeatedly using the same disclosed comparable merely to meet the disclosure requirement.

2. Confidential Expense Data. The appraiser may include confidential expense comparables

in the expense analysis; however, the analysis must include at least one fully identified and disclosed expense comparable to serve as a benchmark. Confidential expense data sources must be disclosed to HUD review appraiser upon request (and subject to confidential requirements similarly imposed on licensed HUD review appraisers). Appraisers may only use confidential expense comparables that are supportive and consistent with the fully disclosed comparables used in the analysis. When submitting confidential expense comparables, the appraiser must redact only the minimum amount of information necessary to protect the confidentiality of their client. The city, state, and general market area within the city must be disclosed unless this information would clearly identify the comparable and thus breach the appraiser's confidentiality requirement. The project description, unit mix, and the physical characteristics of the comparables' units must be disclosed. It is unacceptable for the appraiser to base conclusions on confidential expense comparables that are not supported by the fully disclosed comparables used in the analysis.

3. Review of Insured Expense Comparables. The HRA will compare the FASS or OPIIS systems file for the insured expense comparables used by the appraiser to confirm the data. In order to accomplish this, the HRA will combine the following accounts: Acct. No. 6263T, Administrative Expenses (subtract Acct. No. 6203, Conventions and Meetings, and 6370, Bad Debts), Acct. No. 6400T, Utility Expenses, Acct. No. 6500T, Operating and Maintenance Expenses, and Acct. No. 6700T, Taxes and Insurance.

- F. Expense Adjustments. Project expenses must be expressed in the same units of comparison in order to ensure accurate adjustments and correct reporting of expense estimates. Consistent adjustments for significant differences between the comparables and the subject units shall be derived from the market and applied to the subject expense estimate.

The appraiser must enter the dollar amounts attributable to significant differences between the subject proposal and each of the expense comparables—such as for physical characteristics, equipment, services provided, the level of management furnished to residents and any differences in rates between tax and utility jurisdictions. The appraiser must also correlate the comparable expense for each component which is applicable to the subject project.

- G. Updating Procedures. Appraisers must not trend expenses to reflect a time adjustment from the effective date of the most recent expense comparable to the anticipated date of project occupancy following construction and initial endorsement. Instead, expense estimates must be effective as of the date of the appraisal and must reflect the same year of operation.

The appraiser may use a factor expressed as a percentage to adjust expense comparables up to the same date as the most current expense comparable in order to make a more creditable comparison. However, if all of the expense comparables have data from the same operating year, no adjustment for updating is necessary.

Adjusting expense data is a two stage process, as follows:

First, the oldest comparables are updated to the date of the most recent comparable, so that all comparable data is representative of the same effective time period. Second, after updating the comparables to the same effective time period, the line items are correlated and the subject's expense estimate is updated to the date of the appraisal.

1. The most current comparable is entered in the first column on the HUD 92274. This comparable serves as the benchmark for updating the remaining comparables.
  2. The effective date of the operating expense data is always the beginning date of the operating year. For example, the beginning date of a financial statement dated January 1<sup>st</sup> to December 31<sup>st</sup> is January 1<sup>st</sup> of that year. If the financial statement fiscal year ends June 30, 2000, the beginning date is July 1, 1999.
  3. Other than the first comparable being the most recent, the remaining comparables do not necessarily need to be in chronological order.
  4. The appraiser must enter the comparables itemized expenses as reported on audited, reviewed or certified financial statements. Per unit expenses or per square foot expenses are treated similarly:
    - a. The actual expense amount must be entered in the first column, without any adjustments.
    - b. Once the adjusted per unit expenses are determined for each comparable, the subject project's expenses are then correlated from the array.
    - c. Once the correlated line item expenses for the subject project are determined, they are added and updated to the date of the appraisal.
    - d. The correlated subject expenses are updated based upon the beginning date of the expense period of the most recent (the benchmark) comparable. HUD may request from the appraiser the names and addresses of any confidential expense comparables used in the expense analysis, pursuant to the Confidentiality sub-section of the Ethics Rule, along with Standards 3.1.e and 3.2.f of the USPAP. If the appraiser still refuses to provide this information, the HRA may request additional non-confidential comparables.
- H. The expense line items included in the Section E. of HUD-92264 should be consistent with the individual line items as updated, on the HUD-92274.
- I. Underwritten NOI and General Programmatic Guidance. The following general guidance should be used by underwriters. Assumptions that raise underwritten risks should be stress tested against worst case scenarios and should be evaluated by the underwriter.

1. **Occupancy Standards.** Projects must have an average physical occupancy rate of at least 85%. For market rate properties, the maximum underwritten economic occupancy rate is 93%. For affordable<sup>1</sup> properties, refer to the Section 7.6.G.
2. Projects must demonstrate a pattern of stable physical occupancy, i.e. the average occupancy standards noted above, for a period of six months prior to submission of the Firm Commitment application, and maintain that average occupancy through to the date of Initial/Final Endorsement. Continued occupancy consistent with the underwriting conclusions must be documented with an updated rent roll no more than 30 days prior to closing.
3. The Borrower must submit an updated, certified rent roll detailing the occupancy level at the project. The rent roll must be dated no more than 30 days prior to endorsement. If HUD determines that the updated rent roll shows a significant change in occupancy from that submitted at the time of application and that was assumed in the loan approval, then any Commitment issued shall be of no force or effect and may be cancelled by HUD or amended.
4. Operating Expenses will be stabilized based on the previous three-years operating history where available. Operating expenses, as evidenced by the three-year operating history may require adjustment if capital expenditures (normally considered a reserve for replacement item) have been paid out of the operating budget. Additionally, adjustments to management fee may be made provided a new management contract is executed that reflects a different percentage of gross collection. Adjustments to real estate taxes may be permissible if there is an anticipated tax reduction based on reassessment or reclassification. Annual deposit for the reserve for replacement will be based on the estimate made by the needs assessor in the Capital Needs Assessment.
5. **Exceptions:** Set forth below are exceptions to developing NOI for underwriting Criterion 5 (debt service):
  - a. Projects with units assisted under a Section 8 HAP contract subject to marking down to market or having short terms will size the debt service mortgage at the lower of either:
    1. Market rents as estimated by the third-party appraiser, or
    2. Section 8 HAP rents

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- b. Projects that will have Section 8 HAP contracts with above market rents assured for a long term (at least 15 years remaining) may amortize the additional debt within Criterion 5 (debt service approach) based on two tranches, an A and B piece.
  - 1. The A piece will be determined by underwriting to the market rent levels over the entire term of the mortgage.
  - 2. The B piece will be underwritten as the difference between the market rents and the higher Section 8 rents over the remaining term of the HAP Contract.
- c. First-time refinance of a 202 direct loan. Criterion 5 may use the Section 8 HAP rents (even if they exceed the market). Actual project expenses, as evidenced by the three-year operating history as stabilized, will be used. This assumes that these projects are not subject to restructuring under Mark-to-Market and that no equity will be extracted in the transaction based on above market rents.
- d. Re-refinance of projects which previously had Section 202 direct loans will use the two-tranche method described above. These projects are no longer exempt from Mark-to-Market under MAHRA at the next HAP contract renewal..
- e. Tax Increment Financing (TIF): The TIF income may be underwritten as a second tranche for the term of the TIF only to the extent the offset request NOI is guaranteed or refinanced to obtain anticipated benefits and the TIF would unquestionably not result in a default. The underwritten narrative must provide a complete explanation of the TIF and stress test analysis.
- f. Low Income Housing Tax Credit Projects (LIHTC). Debt Service rents will be the lower of market or tax credit restricted/achievable rents unless there is a Section 8 HAP contract that covers the LIHTC rental units. In the case where there is a long term (at least 15 years remaining) Section 8 contract comparable to market and the tenants will pay no more than 30% of income for their portion of the rent, then the Section 8 rents will be used. If the HAP has less than 15 years remaining, no renewals are necessary, but the lender must underwrite to the lesser of Section 8, market or LIHTC achievable rents. Section 8 contracts with at least 15 years remaining and with exception rents that exceed market (Section 8 overhang) will be underwritten via the two-tranche method described above in 7.8.I.5.b.
- g. Energy/Utility Efficiencies. When an application for a stabilized, operating property proposes green building certification, then 100% of projected savings may offset historic expense, but if no new certification is proposed then only 75% of projected

savings may be underwritten. Refer to Section 6 of the MAP guide or underwriting guidance for projects with energy savings.

See Table in Appendix 7 – Criteria for Loan Sizing, for a summary of Exceptions.

## **7.9 Site Analysis**

Key analyses for consideration of site acceptability for a proposed project are as follows:

- A. Analysis of Location. The analysis of location involves a determination of the desirability and utility of the site, probable future neighborhood trends, the pattern of project and neighborhood improvements and rents in the area.
- B. Specific Location. Consider the specific site in relation to neighborhood and city-wide physical, social, and economic influences, limitations of use imposed by zoning or deed restrictions, development trends, stability, decay and rehabilitation, availability of utilities, services, and appropriateness of the intended use. Review and analyze the various influences which affect its market and income potential, including a review of the crime rate in the area, its impact on the project and how the impact, if any, can be addressed through design or staffing. Race, color, national origin, religion, sex, disability and familial status, which are all Fair Housing Act protected classes shall never be taken into account when conducting an appraisal. No decisions should be made based on pre-conceived notions about characteristics of the area based on the demographics in lieu of statistics. (For further guidance, consult USPAP Advisory Opinion 16, “Fair Housing Laws and Appraisal Report Content”).
- C. Civic, Social and Commercial Centers. Consider the sufficiency of community facilities as they relate to the needs of residents of the proposed project. A location for a multifamily project must be adequately served by elementary and secondary schools, neighborhood shopping centers, transportation, churches, playgrounds, parks, libraries, hospitals, and theaters and other appropriate services.
  - 1. Schools. Accessibility to schools will be judged by the transportation time required, rather than by walking distance alone. Thus, if school bus service will be provided and the time involved is reasonable, the location may be acceptable even if schools are not within walking distance. School capacity is the responsibility of the community and a project that is otherwise feasible will not be rejected because the local schools are considered overcrowded, unless it can be proven that marketability is adversely affected.
  - 2. Neighborhood Shopping Centers. The convenience of shopping should be judged on the basis of time rather than distance. The importance of grocery, drug, and other neighborhood shopping facilities to be within a reasonable walking distance will be heightened based on the number of residents who do not have private transportation.
  - 3. Religious and Recreation Centers. Ready access to religious and recreation centers is desirable. Projects designed for large families have a greater need for playgrounds and active recreation areas. Adequate on-site provisions for playgrounds and other recreation amenities

must be incorporated into the proposal where adequate facilities are not in close proximity to the project site and available for use by occupants.

- D. Transportation. Convenient transportation to places of employment, major shopping districts and civic and social centers is a prerequisite to site acceptability. In those communities where local public transportation is the principal means of commuting by the prospective occupants, the location of a project designed for such occupancy shall be within a reasonable distance to mass transit.
  
- E. Special Hazards and Nuisances. Such conditions include unusual topography, subsidence, flooding, unstable soils, unusual traffic hazards and noise, danger from fire and explosion, exposure to airport noise and low-flying airplanes, smoke, chemical fumes, noxious odors, stagnant ponds or marshes, and sewage disposal failure. Any of these, or similar conditions, if serious and infeasible to overcome, will cause a specific location to be ineligible for mortgage insurance.
  
- F. Parking Facilities. The lender and the third-party reports must consider the impact that parking requirements for the project will have on parking facilities in the neighborhood and on all-night parking, including the availability of other off-street parking, if the project site lacks adequate parking for residents. The loan proposal must estimate the number of parking spaces that would be required and whether or not the proposed parking facilities will meet the estimated need of the residents and their guests. The lender and the third-party reports must consider convenient access to reliable public transportation, because it may in some cases mitigate parking availability concerns.
  
- G. Site Suitability. The site must be adequate in size, shape, exposure, and contour for the proposed project. Building height limitation, project unit size and numbers, necessary on-site parking and play areas must be considered.
  
- H. Land/Site Valuation
  - 1. The site value of land in new construction is to be estimated using all applicable approaches to value, as if the project were unrestricted and market rate.
  - 2. The "As Is" value in substantial rehabilitation cases is to be estimated using all applicable approaches to value based on the current operation of the project.
  - 3. For both 1 and 2 above, no consideration will be given to:

- a. Any additional value that may be attributable to subsidies available to the project or any LIHTCs or other tax benefits the project will receive; or
- b. Any value reduction due to any NOI or value limitations caused by regulatory agreements or affordability restrictions imposed by any subsidy program or tax regulation. This valuation methodology permits sponsors to acquire a project at its market value for new construction or rehabilitation of affordable housing. The value attributable to the presence of LIHTCs diminishes over time and is not always freely transferable, and thus should not be taken into consideration.

**NOTE:** See special instructions for Cost Certification as it relates to As Is Valuation in Chapter 13.21.

4. The site value of land in new construction or the “As Is” value will be noted in the MAP appraiser’s narrative report and in the Remarks section of the form HUD 92264. For the purpose of developing the cost build-up in Section G of the form HUD 92264, the lesser of market value or the acquisition cost will be entered in Section G. Line 74 (Total Estimated Replacement Cost of the Project) is to be entered in Criterion 3 of the form HUD 92264-A.
5. Sites/Projects Sold by a Public Body. For underwriting purposes, where sites/projects are sold by a public body to the developer for a specific re-use purpose, the value of land fully improved is the lesser of:
  - a. The amount determined by comparison with other sites possessing the improvements and amenities that the subject site will have upon completion.
  - b. The dollar amount paid by the purchaser under the purchase contract with the public body, plus an estimate of any additional costs imposed by its terms or by the insurance program. Such costs are those to be borne by the purchaser under the purchase contract including real estate taxes and special assessments accruing from date of purchase to date of commitment, legal fees incident to the land/project purchase, re-zoning costs, installation of certain designated off-site improvements, razing structures and clearance of the site (after allowance for any income to the purchaser) and environmental abatement. This is not a complete list of items covered but serves as a guide to the acceptability of costs required by the purchase contract.
  - c. The actual values are noted in the MAP Appraiser’s narrative and in the Remarks Section of the 92264.
  - d. In the case of non-LIHTC developments that otherwise meet the definition of affordable per Section 3.1.L of the MAP Guide, all or a portion of the residual land value assignable to the affordable units in the transaction may be included in Criterion 3, as long as the land value is constrained by a valuation consistent with an affordable development (as opposed to a market rate site valuation). For purposes of

clarification, the site value used for affordable housing may be lower than the corresponding value if all of the units were operated at market. The units that are restricted to rents below area market rents (established in the appraisal) would not contribute the same value to the underlying land as the market rate units. In some cases, the value may pose a negative impact for each unit restricted as the amount of rent generated would likely not cover expenses. Thus, the impact of the rents in this case must be thoroughly analyzed.

e. The appraised value of the land may be included in Criterion 3 in the event that the public entity maintains ownership in the transaction, and the project meets the definition of affordable per MAP Guide section 3.1.L.

6. “As-Is” Value of Land. HUD’s estimated value of land or project “as is” for cost certification may include all of the items in paragraph 5.b above with the following exceptions: Installation of off-site improvements and cost of razing structures and clearing the site (less income received). This is intended to avoid duplication of costs that might be reflected in the estimated value of land “as is” and also allows for the sponsor to include them as separate items in cost certification which includes both off-site costs and demolition. The dollar amount of the land purchase contract plus a breakdown of the estimate of additional costs must be fully itemized and documented.

NOTE: Cost Certification instructions (enforced by Statute) dictate that the lesser of the “as is” value of the land and improvements (before repair or rehabilitation) or the purchase price of the land and improvements, is used in the cost build up for Criterion 3 of form HUD 92264A, in substantial rehabilitation cases. Consequently, when mortgage proceeds will be used to fund the acquisition of the project, the “as is” value estimation will be used as a test of the reasonableness of the acquisition price.

When the acquisition price is less than the “as is” value of the land and improvements (as accepted by HUD), and mortgage proceeds will be used to fund the acquisition of the project, the acquisition price will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment

When the acquisition price exceeds the “as is” value of the land and improvements (as accepted by HUD), then the acquisition price must be reduced to the “as is” value and will, subsequently, comprise the basis of the cost build up for the Firm Commitment.

When mortgage proceeds will not be used to fund the acquisition of the project, the “as is” market value of the project will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment. This is particularly significant when below market rent

restrictions, (such as in the case of LIHTC limited rents or Section 8 rent subsidy) are in place and the use of market rents in valuing the project will result in a premium over these rent restrictions.

- I. Warehousing of “excess” land area is not encouraged but where un-avoidable, it may be permitted but may not be funded with insured mortgage proceeds.

## **7.10 Pre-Application Stage for Sections 220, 221(d) and 231**

### **A. Lender’s responsibilities:**

1. Based upon the market study prepared by the market analyst and the rental income and expense estimates prepared by the appraiser, the lender is responsible for making the following determinations before submitting the application:
  - a. Determine the current occupancy levels, market absorption rates and market demand for the number and type of units proposed.
  - b. Analyze site for acceptability.
  - c. Determine market rents reflecting amenities, services, equipment offered and estimate project income.
  - e. Estimate total operating expenses. HEROS reports (including the Phase I ESA) should be consulted to determine if additional carrying costs are to be included in the operating expense summary.
  - f. Estimate mortgage amount based on form HUD-92264-A, Criteria 5, and Debt Service Ratio.
  - g. Make a determination of feasibility or non-feasibility of the sponsor’s proposal.
  - h. Evaluate the market study and appraisal report. The lender will either accept their conclusions for use in underwriting or may revise them for underwriting purposes. Any such revisions must be explained and justified. The lender may adjust the appraised value downwards but may not adjust it upwards. Once accepted by the lender and submitted to HUD as part of the lender’s application, the lender assumes the validity of the findings and conclusions of the appraisal.
2. The HEROS (HUD’s Environmental Review Online System) report, including a Phase I ESA must be prepared in accordance with Chapter 9 and the lender should advise the market analyst and the appraiser of any conditions which might affect the marketability or value of the project.
3. The appraiser or market analyst must prepare the market study in accordance with the requirements of this Chapter.
4. The appraiser must determine project rents, estimated rental income, operating expenses

the warranted price of land or “as is” value (of land and buildings for substantial rehabilitation cases). The lender must assure that the forms HUD-92273, Estimate of Market Rent by Comparison, and HUD-92274, Operating Expense Analysis Worksheet, are prepared. For substantial rehabilitation projects, the appraiser must estimate the rents and expenses based on the assumption that all proposed substantial rehabilitation to the project has been completed and is used as the basis for NOI in the debt service criterion. However, pre-rehabilitation rents and operating expenses must be used for purposes of developing the cost build up and determining as-is value.

5. The lender must consider cost information from various sources, including the sponsor, appraiser, and cost consultant (including soft-cost and land cost information) to calculate the total replacement cost and will compare its estimate of total replacement cost with the costs estimated by the borrower.
6. Complete the forms HUD-92264, HUD92264-A, and supporting forms.
7. The lender must compare the calculations on the form HUD-92013 with those proposed by the borrower and either accept the borrower’s proposal, recommend its modification, or reject it and advise the borrower that the project is infeasible.

## **7.11 Firm Commitment Processing for Sections 220, 221(d) and 231 (New Construction)**

### **A. Lender’s Responsibilities:**

1. Contract for an appraisal establishing the replacement cost for the project utilizing the cost approaches in accordance with requirements found in Section 7.6. The appraiser will update the rental and expense analyses provided in the Pre-Application.
2. The appraiser is also required to determine the “warranted price of the land” for new construction projects and the "as is" value of the project for substantial rehabilitation projects. In addition, for Section 231 substantial rehabilitation projects, the appraiser must also determine the “value fully improved” of the project site.
3. The lender must forward or otherwise coordinate sharing information prepared by its cost analyst and any soft-cost and land cost information provided by the sponsor with the appraiser for assistance in the calculation of the total replacement cost.

In accordance with USPAP Standard 2-3, “When a signing appraiser(s) has relied on work done by appraisers and others who do not sign the certification, the signing appraiser is responsible for the decision to rely on their work. The signing appraiser(s) is required to have a reasonable basis for believing that those individuals performing the

work are competent. The signing appraiser(s) also must have no reason to doubt that the work of those individuals is credible.”

4. The lender must assure that all applicable sections of the Rental Housing Project Income Analysis and Appraisal, form HUD-92264, are completed in accordance with current policy, for the type of project proposed.
5. Form HUD-92664 items to be calculated by the appraiser include:
  - a. Market rents and estimated income
  - b. Estimated total operating expenses
  - c. Total estimated replacement cost of the project
  - d. “Warranted Price of the Land” for new construction projects and the "As Is" value of the land and building for substantial rehabilitation projects
  - e. Estimate of operating deficit and replacement reserve
  - f. Estimate of REL
  - g. Estimate of Interest during Construction (line 53 in section G of Form HUD-92264), to be calculated as the greater of i or ii below:
    - i. By formula. The amount of the mortgage multiplied by 0.5, multiplied by construction interest rate and multiplied by construction years. (Construction Years is the construction time in months from line 52 in section G of the Form HUD-92264 plus 2 months, then divided by 12).
    - ii. Lender’s estimate (optional). The lender’s estimate of interest during construction must be documented with a pro-forma draw schedule or its equivalent, subject to USPAP Standard.
    - iii. HUD’s HRAs and underwriters may suggest modifications to elements of the appraisal and methodology of the appraisal conclusions internally or may return the application to the lender for modification. See Chapter 11 Section 11.2 for review by MF Regional Center/Satellite Office staff.
6. The lender must provide written explanations in the underwriter’s narrative of and major changes to the pre-application invitation letter. Any inconsistency between the data reported on a form HUD-92264 prepared by the appraiser and the lender’s HUD-92264 must be explained in the Underwriting.

## **7.12 Firm Commitment Processing for Section 223(f)**

### **A. Lender’s responsibilities:**



1. The Underwriting Narrative must demonstrate that the MAP Underwriter performed adequate due diligence in reviewing the appraisal which shall include a thorough discussion comparing the appraiser's market analysis to the conclusions from the market study, in cases where a separate market study is required. There must also be a full discussion by the underwriter of the approaches to value and the appraiser's reconciliation and value conclusion.
2. The lender must state any reasons for disagreement with the appraisal report. The underwriting summary should contain a thorough discussion of any differences between the value conclusions made by the appraiser and those conclusions used in underwriting the loan. The appraiser's value conclusions may be adjusted downwards by the underwriter but may not be adjusted upwards.
3. The appraiser must complete an appraisal of the project establishing market value utilizing the cost, income, and comparable sale approaches. The Cost Approach may be eliminated at the discretion of the appraiser for subjects that are ten or more years old, although an estimate of the land value must still be provided.
4. The appraiser should participate in the inspection of the project with the Capital Needs Assessor where practicable.
5. The appraiser must consider the eligibility of the project, confirm the project occupancy level, and verify the owner's rent roll during the inspection. When the appraiser has established that the owner's rent roll is correct, the actual occupancy, based on the owner's rent roll must be entered in the Remarks Section of Form HUD-92264. The appraiser must also determine whether the apartments are furnished or unfurnished.
6. The appraiser must analyze the project for acceptability.
7. The lender must confirm that the HEROS report, including the Phase I ESA is prepared in accordance with Chapter 9 of the MAP Guide with all appropriate directives.
8. The lender must assure that the appraiser completed the forms HUD-92273, Estimate of Market Rents and HUD-92274, Operating Expense Analysis Worksheet. This is based on the determination made by the appraiser of the project's income and operating expenses including a review of the operating history of the project (rent roll and financial statements).
9. The lender must assure that all applicable sections of the Rental Housing Project Income Analysis and Appraisal, form HUD-92264, are completed in accordance with

current policy, for the type of project proposed. HUD-92264 items to be calculated by the appraiser include:

- a. Market rents and estimated income
  - b. Estimated total operating expenses
  - c. Total estimated replacement cost
  - d. “Warranted Price of the Land”
  - e. Market value of the project
  - f. Estimate of operating deficit as necessary and replacement reserve
  - g. Estimated and actual occupancy rate
  - h. REL
10. The data provided in the lender's HUD-92013 and lenders HUD-92264 must be consistent, and any inconsistency between the data reported on a HUD-92264 prepared by the appraiser and the lender’s HUD-92264 must be explained in the Underwriting Summary.

### **7.13 Substantial Rehabilitation Processing for Sections 220, 221(d)(4) and 231**

- A. In general, a substantial rehabilitation project is processed in accordance with the instructions found in Sections 7.10 and 7.11, except as noted below.
- B. Form HUD-92264 must be completed in accordance with basic valuation instructions for Sections 221(d)(4) and 220 processing, with the following modifications:
  1. “As Is” Value. Development of the “As Is” value must be in accordance with the pertinent requirements of Standards 1 and 2 and the applicable approaches to value. A supplemental HUD 92264 is not required.
  2. The forms HUD-92273 and HUD-92274 analysis used to support the income and expenses on the HUD-92264 must reflect the “as completed” project conditions that will exist after substantial rehabilitation has taken place.
  3. A value for the land without improvements must be estimated and entered using the analysis grid in Section H of the form HUD 92264.
  4. The “as is” value and the value of the land without improvements must be entered in Section “O” (Remarks) of the form HUD 92264.

C. Applicable Approaches - "As Is" Value in Substantial Rehabilitation. The estimate of "As Is" value of the land and building before rehabilitation should be estimated by the direct market comparison approach and the income approach to value. The "As Is" value by the residual approach is not mandatory, but can be used in cases where there is a lack of market sales. This estimate of value assumes an arm's length transaction between the subject and a typical purchaser of the subject in its current state with respect to condition and income, including the current presence of a subsidized income stream. To determine value based upon the income approach, the appraiser should use the lesser of market rent or the income derived from any rental assistance contract, as applicable, to avoid inappropriately inflating income and thereby the estimate of value. Moreover, the estimate does not assume any advantages or disadvantages associated with the current sale or refinancing of the subject that would involve issuance of tax credits or other development advantages.

NOTE: See special instructions for Cost Certification as it relates to As Is Valuation in Chapter 13.21.

D. Valuation Processing: (Sections 220, 221(d)(4)).

1. Determine the market value of the project "As Is". Complete the Location and Description of the Project, Information concerning Land or Project, Estimate of Income, Equipment and Services Provided in Rent, Estimate of Annual Expenses, Income Computations, and Income Approach to Value, and Sales Comparison Approach to Value within the report. If the project involves rehabilitation and new construction with additional land to be added, also complete a land appraisal for that portion of the land to be added for the new construction portion of the development proposal.
2. Use the Replacement Cost by Formula, Rehab Projects, with or without BSPRA, to find the total project cost (summation estimate) using the "As Is" market value of the project, and the rehabilitation cost estimate furnished by the cost analyst, plus carrying charges and financing.
3. Complete HUD-92264. In Section G, the "As Is" market value of the project before rehabilitation will be shown on the line titled "As Is" value of project except as noted below.
4. "As Is" value of project acquired as a leasehold estate. Instructions for limiting the "As Is" value of project before rehabilitation, when that project is acquired as a leasehold estate, are found in Ground Leases, Section 7.15.
5. To find the project mortgage amount for Section 220 and Section 221, use the lowest of Criteria 1, 3, 4, or 5 on HUD-92264-A. Estimate the "As Is" value of the project before rehabilitation, add the total for all improvements plus soft costs to the As-Is Value to obtain the sum of the above costs. Then multiply the sum of the project costs listed above by the applicable percentage based upon Criterion 3 to obtain the maximum project mortgage amount.

**NOTE:** Cost Certification instructions (set by Statute) dictate that the **lesser** of the “as is” value of the land and improvements (before repair or rehabilitation) **or** the purchase price of the land and improvements, is used in the cost build up for Criterion 3 of form HUD 92264A, in substantial rehabilitation cases. Consequently, when mortgage proceeds will be used to fund the acquisition of the project, the “as is” value estimation will be used as a test of the reasonableness of the acquisition price.

When the acquisition price is less than the “as is” value of the land and improvements (as accepted by HUD), and mortgage proceeds will be used to fund the acquisition of the project, the acquisition price will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment

When the acquisition price exceeds the “as is” value of the land and improvements (as accepted by HUD), then the acquisition price must be reduced to the “as is” value and will, subsequently, comprise the basis of the cost build up for the Firm Commitment.

When mortgage proceeds will **not** be used to fund the acquisition of the project, the “as is” market value of the project will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment. This is particularly significant when below market rent restrictions, (such as in the case of LIHTC limited rents or Section 8 rent subsidy) are in place and the use of market rents in valuing the project will result in a premium over these rent restrictions. (See Section 7.13 C, defining how rents are derived as the basis for the “as is” value)

- E. Valuation Processing for Section 231 Substantial Rehabilitation Cases. Section 231 substantial rehabilitation cases require two value estimates, a value subject to the completion of rehabilitation using all applicable approaches, which shall be used in Criterion 3 of the Form HUD-92264-A, and an “As Is” value entered in Section G, line 73b of the Form HUD-92264 to determine the Total Replacement Cost of the Project, in a manner similar to the procedure used in Sections 220 and 221(d) (4). Depreciation is not included. The value upon completion of the project should reflect that which could be obtained through an arms-length sale. If rental restrictions exist and will survive post sale, then the value will be based upon these limitations. Alternatively, if the restrictions terminate upon sale, then the As-Is estimate would reflect the higher value. The “As Is” value is also used in completing Criterion 6 of the Form HUD-92264-A.

If the Total Estimated Replacement Cost of the Project (Line 74 of Section G of the 92264) exceeds the value after rehabilitation, the residual “As Is” value by formula must be completed. This amount must be entered on line 73b of Section G, and Section G, line 74 will be considered to be the value of the project after rehabilitation and this amount must be entered in Criterion 3 of the Form HUD-92264-A.

- F. Valuation Processing for RAD Transactions. On RAD 221(d) (4) substantial rehabilitation transactions, the appraiser should use the CHAP rents and historical occupancy and operating expenses if available to set value.
- G. Contingency Reserves. To address unanticipated costs inherent in the rehabilitation of older structures, there will normally be included in the mortgage amount a reserve for contingencies based on the percentage of estimated rehabilitation cost without fees. This percent may range between 10 and 15 percent, depending upon the scope and type of rehabilitation and the experience and financial ability of the sponsor, the borrower and contractor and on whether the contractor's bid already contains a reserve for contingencies. This percentage, determined by the cost analyst, must be included as a separate line item in the estimate of replacement cost on HUD-92264.
- H. Interest during Construction. Interest during construction for substantial rehabilitation (line 53 in section G of Form HUD 92264) must be calculated as the greater of:
1. By Formula. The amount of the mortgage multiplied by 50 percent, multiplied by construction interest rate and multiplied by construction years. (Construction Years is the construction time in months from line 52 in section G of Form HUD-92264 plus 2 months, then divided by 12).
  2. Lender's Estimate (optional). The lender's estimate of interest during construction must be documented by a pro forma draw schedule or equivalent.
- I. Inspection Fee. The inspection fee is calculated as half of one percent (0.5%) of the loan amount when the project involves new construction. For substantial rehabilitation projects, the inspection fee is calculated as the sum of Total for All Improvements times one half of one percent (0.5%) rounded to the next higher \$100.
- J. Offsite costs. If there are any offsite costs associated with the rehabilitation, enter them as a line item in the Estimated Replacement Cost. This separate entry is necessary in rehabilitation processing, since the "As Is" value does not include offsite cost requirements.
- K. Rehabilitation cost not attributable to residential use. This entry must be completed for all rehabilitation projects and is prepared on Rehabilitation Cost Not Attributable to Residential Use, found in the MAP Form Book, and transferred to line 4b under Criterion 4, Amount Based on Limitations per Family Unit, HUD-92264A.
- L. Developer's Fee, when applicable. HUD may include in the estimated replacement cost of a project, a nonprofit developer's fee in addition to the legal, organizational and audit fees normally included in the estimated replacement cost of a project.
1. The fee will be based on a sliding scale at eight percent of the mortgage, but not less than \$40,000 or more than \$400,000.
  2. Exceptions:

- a. For mortgages in excess of \$5,000,000 increase the maximum fee to provide an additional 2 percent based on that portion of the mortgage that is in excess of \$5,000,000.
  - b. At the option of the nonprofit sponsor/borrower, the fee included in the replacement cost may be reduced.
3. Part or the entire fee may be used to pay for transactional costs related to developing the subject project including but not limited to:
- a. Reduction of the estimated closing costs of the project
  - b. Staff salaries
  - c. Nonprofit working capital deposit
  - d. Relocation expenses
  - e. Operating deficit escrow
  - f. Financing fees above the 3.5 percent included in the estimated replacement cost of the project;
  - g. Environmental studies
  - h. Housing Consultant services provided by either in-house staff or contractor
4. Funds not used to meet the estimated cash requirements of the project will be released to the nonprofit based on a percentage of completion method.
- M. Items no longer included in the Estimated Replacement Cost of a Project. HUD will no longer include in the estimated replacement cost of a project, an Allowance to Make Project Operational (AMPO) and an amount for Housing Consultant services except as part of the developer's fee noted above.

## **7.14 Calculating Operating Deficits**

A. Estimate of a Project's Operating Deficit. When it is anticipated that the project's net income will be inadequate to support the insured loan during the initial rent-up period, the appraiser must estimate the anticipated project operating deficit, utilizing the following steps:

1. Estimate the total project operating expenses, add the debt service requirement (including

principal, interest and mortgage insurance premium (MIP)) and divide the total by the potential gross income for the project. The resultant ratio is the break-even occupancy level. Multiply that percentage times the total project units to obtain the number of units required for break-even occupancy (rounding up any fraction of a unit).

2. Estimate the total number of units expected to be occupied at the time of Final Endorsement. The difference between the total units required for break-even occupancy and those occupied units at the time of Final Endorsement represent the total number of units that must be rented in order to reach a break-even occupancy level.
3. Estimate the likely rate of absorption of the available units, taking into account the current and proposed supply of housing units in the subject's market balanced against demographic and demand considerations. The absorption or lease-up rate must be supported by comparison to similar project's historic rates of absorption during their lease-up period whenever such a comparison can be made. The number of units to be absorbed, divided by the monthly absorption rate, will yield the total number of months of the entire operating deficit period.
  - a. Absorption Period. The Absorption Period is the period of time necessary for a newly constructed or renovated project to achieve stabilized occupancy. The absorption period begins when the first certificate of occupancy is issued and ends when the last unit to reach stabilized occupancy has a signed lease and is actually occupied by a resident. A typical pre-marketing period begins about three to six months prior to the issuance of the certificate of occupancy, therefore the month that leasing is assumed to begin should accompany all absorption estimates. It is important to consider that the absorption of restricted/low-income units may be different, depending on the differential in rent between low-income rents and market rents, and the number of income-qualified potential residents in the HMA.
  - b. Maximum Allowable Absorption Period. As a result of risk mitigation guidance, the absorption period used in estimating market demand for the proposed number of units has been reduced from 24 to 18 months. Larger projects may phase additional units under a separate application for mortgage insurance (e.g. under Section 241(a)). An exception to the 18-month absorption period limitation may be waived by the Regional Center Director for large high-rise buildings. Such projects will be evaluated based on their own merit and will require a larger initial operating reserve to insure against the risk inherent in a longer absorption period.
  - c. Absorption Rate. The Absorption Rate is the average number of units rented each month during the absorption period.
4. Because the deficit period can begin at certificate of occupancy and continue through the

cost certification phase and the amortization phase, there are three distinct expense intervals to consider when calculating the total deficit period, although not every project will require using all three intervals.

**Interval 1** covers the time between certificate of occupancy and the end of the construction period and cost certification. (Note that the construction period is defined as construction time plus two months for cost certification purposes). This is an optional interval, because some projects may have the same certificate of occupancy and construction completion dates and thus would not need an Interval 1. When calculating expenses for this Interval, no debt service is to be included as an expense since the mortgage interest for this interval is included in the mortgage in Section G Line 53 "Construction Interest". Replacement Reserves and ground rent are not to be included in Interval 1. This interval must only include the appraiser's estimate of all of the applicable operating and leasing expenses for each month (period).

**Interval 2** begins at the end of the construction period/cost certification process (construction time plus two months) and ends at the beginning of loan principal amortization. This period can be no greater than 2 months and is also an optional interval. (Chapter 8 Section 8.9.A.2. requires amortization to begin "no later than 4 months after construction completion for insurance of advances and first day of second month after final endorsement for insurance of completion cases"). If amortization begins at the end of the construction period, this interval will not be necessary. Debt service must include payment of interest and MIP, but not amortization, as the beginning of amortization signals the beginning of Interval 3. (Section G Line 53 of the HUD-92264 includes mortgage interest for the construction period plus two months. If amortization is deferred until 4 months after construction completion, there will be two months of unaccounted-for interest and MIP that must be included in the IOD). Ground rent must be included if the project is a leasehold since only ground rent during construction can be included in the mortgage, and this interval begins after construction completion. Replacement reserves are not included in interval 2. This interval must include the appraiser's estimate of applicable operating expenses for each month (period).

**Interval 3** begins at the beginning of amortization. Amortized debt service is mandatory in this interval, and must include payment to principal, interest and MIP. Ground rent, if applicable and replacement reserves are also mandatory in interval 3. This interval must include the appraiser's estimate of applicable operating expenses for each month (period). Interval 3 ends when NOI becomes positive and is sufficient for breakeven coverage of the mortgage debt.

B. Operating deficits can occur before and after the start of amortization. The operating deficit calculation for the first interval must begin when the Certificate of Occupancy is secured.



- C. If the dollar amount of debt service for a period is greater than the net income for that period, the difference represents the estimate of the operating deficit. One period of positive income does not cancel a prior period of income deficiency.
- D. The operating deficit represents the total of all cumulative losses projected to occur before the project reaches breaks even and produces a positive cash flow. These losses may not be offset by intermittent periods of positive cash flow.
- E. Where commercial facilities are included in the project, a separate operating deficit estimate of income loss for commercial rent-up must be prepared. The appraiser must insure that expenses included in the residential deficit estimate are not duplicated in the commercial space deficit estimate so as to unfairly penalize the project. The commercial space deficit is added to the residential operating income deficit to determine the total project operating deficit escrow funding that will be necessary. Any positive income attributable to the commercial space during the deficit period will not offset the residential operating deficit requirements.

## **7.15 Leaseholds/Ground Leases**

- A. HUD may insure a leasehold deed of trust (or mortgages) that constitutes a mortgageable interest under the law of the state in which the project is located and otherwise meets the requirements of the National Housing Act and this Section. However, HUD prefers to provide insurance on deeds of trust and mortgages secured by a project owned in Fee Simple. The MAP Lender's underwriting and appraisal analysis must fully describe the interest in a Leasehold Estate transaction and related values. Except as specifically noted below, waivers of this Section and modifications to the HUD Lease Addendum (form HUD-92070M) are not permitted in the field and must be processed in HQ except for affordable transactions with a governmental entity as the lessor.
- B. Definitions.
  - 1. Fee Simple (Estate). An ownership interest in land that is the broadest property interest allowed by law, extending beneath the soil to the air above, and which endures until the last holder dies without heirs.
  - 2. Leasehold (Estate). A Tenant's possessory interest in land for a term of years granted to the Tenant pursuant to a lease agreement. Upon expiration of the Lease term, all rights to possess and use the land revert back to the Landlord (Fee Simple owner) and the leasehold estate terminates. A leasehold interest can be in the land only (ground lease) or the land and building and improvements.
  - 3. Leased Fee. A Landlord's interest and rights to the leased property, including the right

to receive rental income and a right to possess the property at the end of the lease.

4. Tenant. An entity with a possessory interest in the land granted by the Landlord through a Lease, typically the single asset borrower entity, *i.e.*, the HUD Borrower.
5. Landlord. The owner of the Fee Simple interest in the land (and sometimes improvement on the land) who grants the Tenant the temporary possessory interest in the land (and improvements, if applicable).
6. Lease. A contract for exclusive possession of lands or tenements for a determined period. Note that the *Lease Addendum – Multifamily* (form HUD-92070M)) uses the term Lease to refer to Leasehold Estates comprised of the land (or air) and Improvements, but for purposes of this Section, Lease may refer generally to a lease of land and improvements, a Ground Lease or an Air Rights Lease.
7. Ground Lease. A particular form of Lease - typically a long-term contract between the Landlord and Tenant granting the Tenant an exclusive possessory interest in land for a term of years in return for lease payments or rent. A Ground Lease for purposes of this Section does not include improvements.
8. Rent or Ground Rent. Money paid by Lessor to Lessee in exchange for the exclusive use and enjoyment of the land or improvements.
9. Improvements. Improvements are a permanent addition to real property (land).
10. Operating Expenses (See Section 7.7).
11. Taxes. Project taxes and special assessments. Taxes shall not include income taxes. Net income before Debt Service Payments shall mean the annual amount which remains after operating expenses and taxes are subtracted from Effective Gross Income.
12. Debt Service Payment. The annual amount paid to mortgage principal, interest, and MIP.
13. Net Cash Flow. The annual amount remaining after Debt Service Payments are subtracted from net income.
14. Air Rights. The right to undisturbed use and control of designated air space above a specific land area within stated elevations. Air rights may be acquired to construct a building above the land or building or another or to protect the light and air of an existing or proposed structure on an adjoining lot. The rights may be transferable, which is an air right, that cannot be used by the landowner, or that the owner chooses not to use, but can be conveyed to landowners in another location.

### C. Legal Requirements.

1. Borrower's Interest in Property. The Tenant/Borrower must have a mortgageable interest in the property comprised of:
  - a. A Leasehold interest in the land– *Lease Addendum – Multifamily* (form HUD-92070M) (Option 1 “Ground Lease”); or
  - b. A Leasehold interest in the land and building/improvements – *Lease Addendum – Multifamily* (form HUD-92070M) (Option 2 “Lease,” permitted only in cases where the Landlord is a public/governmental entity); or
  - c. A Leasehold interest in the air rights– *Lease Addendum – Multifamily* (form HUD-92070M) (Option 1 “Air Rights Ground Lease”).
  - d. A Leasehold interest in air rights and improvements – *Lease Addendum – Multifamily* (form HUD-92070M) (Option 2 “Air Rights Lease,” permitted only in cases where the Landlord is a public/governmental entity);
  - e. For Leaseholds of trust lands or Native American tribal land, HUD must ensure that the Lease provisions, including the term of the lease and any waivers of Lease Addendum provisions, are acceptable to both HUD Headquarters and the Bureau of Indian Affairs.

**NOTE:** In all cases the Landlord must be the Fee Simple owner of the property and must grant the leasehold estate directly to the Tenant (i.e., the Borrower). This prohibition against insurance of mortgages on sub-leasehold estates is statutory for Sections 207/223(f) and 231 and cannot be waived for these programs.

2. Lease.
  - a. *Term of Lease.* The term of the lease must comply with the National Housing Act and cannot be waived.
    - i. Sections 221(d) and 220: the term of the lease must run at least ten (10) years beyond the maturity date of the mortgage or for a period of not less than 99 years which is renewable.
    - ii. Sections 207/223(f) and 231: the term of the lease must run at least fifty (50) years beyond the date of mortgage execution or for a period of not less than 99 years which is renewable.
    - iii. Section 223(a)(7): The term of the lease is subject to the requirements of the original mortgage program for the project being refinanced.
    - iv. Section 241(a): The term of Lease (from the insured first mortgage) may remain the same except if the 241(a) loan is being extended beyond that of the insured first mortgage, the term of Lease must be extended by a corresponding number of years in cases where the original Lease term is other than 99 years and renewable.

- b. *Recording*. The Lease or a Memorandum of Lease must be recorded in the applicable land records office and must contain the following information (in addition to any information required by state law):
- 1) The names of the parties (Landlord and Tenant);
  - 2) A legal description;
  - 3) Term of the Lease and any option to renew;
  - 4) Reference to the HUD *Lease Addendum – Multifamily*, form HUD-92070M; and
  - 5) Specific reference to HUD’s option to purchase in Section 7 in the HUD Lease Addendum (unless Section 7 is expressly waived in writing by HUD in accordance with Program Obligations).
- c. *Lease Addendum – Multifamily* (form HUD-92070M).
- 1) The Lease must incorporate the *Lease Addendum - Multifamily* form HUD-92070M (“Lease Addendum”). If the Lease has been recorded, the Lease Addendum must also be recorded in the official records to amend the previously recorded Lease. If a Memorandum of Lease has been recorded, it must be amended in the official records to reference the incorporation of the Lease Addendum as noted above.
  - 2) Option to Purchase (Section 7 of form HUD-92070M). The Lease, through the incorporation of the Lease Addendum, must grant HUD the option to purchase good and marketable fee simple title to the property and the Landlord’s interest, if any, in the building and improvements.
    - a. Option Price. HUD’s option price must be the value of the Leased Fee Estate (net present value of Ground Lease) at the time of Firm Commitment (see section 7.15.E regarding valuation of the leasehold interest).
    - b. Waiver. If the Landlord is a state or local unit of government or public entity created pursuant to state law, the Regional Center Director may waive the purchase option requirement at the time of issuance of the Firm Commitment. To be eligible for this waiver, the project must also:
      - i. Be “affordable” as defined in Section 3.1.L, OR be a low-leverage, low-risk loan with significant public purpose and benefit;
      - ii. Be appraised for both Leased Fee and Leasehold interests, as well as the Fee Simple interest in the land. The Leased Fee is the net present value of the Ground Lease ; and
      - iii. Provide a thorough discussion in the appraisal and underwriting narrative of the Lease terms, and a

determination by Lender that both the Leasehold Estate is marketable and the Leased Fee is less than the Fee Simple interest in the land .

- iv. Additionally, HUD will permit the use of discounted cash flow analysis and/or direct capitalization in determining the value of the Leased Fee. The Lender must include a thorough discussion of the parameters and methods used in the determination of the discount rate. The value of the Leasehold Estate will be accounted for in form HUD-92264A on line 3(a) and will be used to calculate the maximum insured mortgage for purposes of Criterion 3. No value is given to the Leased Fee under either Criterion 3 or 4.

3) 223(a)(7). Execution of a new Lease Addendum is not required for 223(a)(7) transactions.

- d. *Estoppel Certificate*. The Tenant/Borrower must provide an estoppel certificate signed by the Landlord that identifies the Lease documents, including all amendments, and confirms: the legal description, that the Lease is in full force and effect, and that there are no defaults, pending defaults or conditions that could give rise to a default under the Lease. The estoppel certificate must also contain the required language from 24 C.F.R. § 200.62 and the “warning” language from the Lease Addendum. The estoppel certificate must be dated within 30 days of closing.

#### D. Lease Payments (Ground Rent).

1. Acceptable Form of Ground Rent Computation. For all Leasehold projects, the Ground Rent must meet the underwriting standards of this MAP Guide. Ground Rents may be computed using one of the following three methods:
  - a. A fixed percentage of Gross Collections (or Effective Gross Income). The percentage must remain the same throughout the term of the Lease.
  - b. A fixed percentage of net cash flow to equity (after Debt Service Payments but before Lease payments). The percentage must remain the same throughout the term of the Lease.
  - c. A stated dollar amount per year which must remain fixed for at least ten years beyond the term of the insured mortgage. If monthly or quarterly payments are required, these will be converted to annual amounts by the appraiser. When the Lease contains more than one method of computing the Ground Rent, it must also indicate whether the amount to be paid is to be the greatest or the least, or

the sum of these amounts. The stated annual dollar amount may be described as a minimum payment.

The MAP appraiser must evaluate the payment based upon the acceptable Ground Rent computations, and incorporate the payment into their conclusion of net operating income.

2. Unacceptable Lease Payments (Ground Rent). HUD will not accept variable Ground Rents, including (1) graduated schedule of future increases on a lump sum/year-by-year basis, (2) Cost of Living Allowance (COLA) or Consumer Price Index (CPI) increase, and (3) increases based on the results of future appraisals or arbitration.
3. Ground Rent During Construction. Ground Rent during construction must be included in the estimated replacement cost of the project and in the certified cost, subject to the following conditions:
  - a. The period for which Ground Rent is estimated must be the same as that for which interest and other related charges are calculated, or, the estimated construction time plus two months.
  - b. Ground Rent during construction must be entered in Line G 69 of Form HUD-92264 (currently labeled “Construction Fee”). A remark must be entered in Section H, indicating that the amount in Line G 69 represents Ground Rent during construction.
  - c. Ground Rent must not be included in the base on which Section 220, 221(d) BSPRA is calculated.
  - d. The annual amount of Ground Rent during construction may not exceed the test for acceptability of Lease payments.
  - e. For rehabilitation under all Sections of the Act, Ground Rent during rehabilitation must be included in the replacement cost.

E. Valuation of the Leasehold Estate. The value of the Leasehold Estate is determined by analyzing the factors used by the MAP Appraiser in developing a value for Criterion 3 such as income capitalization supported by sales comparables and included on line 3.a of the Form HUD 92264-A.

1. For affordable projects that involve a ground lease on land or on both land and improvements without an option to buy. The Department will not insure a loan that will recognize a leasehold interest for security unless the property meets these requirements:
  - a. The lessor must be governmental body or a housing authority, or a non-profit entity. There are no exceptions and no waivers at the Regional level.
  - b. The project must meet the affordability requirements set forth in 7.15.E.1.d.below, as well as the underwriting requirements set forth in 7.15.E.1.e-g, below.

- c. No deviations from form HUD-92070M are permitted, except for those previously stated.
- : d. Qualify as affordable housing, as defined in Section 3.1.L as well as the underwriting requirements set forth in Section 7.15.g.4.c-g, below;
- e. Be a low leverage, low risk loan with significant public purpose benefit.

2 . Valuation methodology and analysis must clearly outline the various components of the lease and the Highest and Best Use section of the Appraisal must present the appropriate analysis and methodology that reflects the following:

- i. Value of the Fee Simple Interest in the Land per requirements in the MAP Guide, typically supported by comparable sales and reflected elsewhere in the appraisal. The specific components of the fee simple estate must be clearly defined, i.e. land, land and shell, land and building, etc.
- ii. Value of the Leased Fee must reflect the Net Present Value of all lease payments and the appropriate risk to collecting those payments. The value must reflect the typical terms in the market by a typical investor and may be appropriately reflected by both a capitalization of the initial income for the current year lease and by using a Discounted Cash Flow. Any/all variances in value between these two methodologies must be analyzed and explained in terms of the risk to HUD.
- iii. The impact of the Leased Fee Value on the Leasehold Estate must be clearly discussed and reflected in the Leasehold Value estimated in the Income Approach, and any/all adjustments must be reflected in the value determined by the Sales Comparison Approach.
- iv. The resulting value of the Leasehold Estate must be analyzed and reported in Section G, Line 73b of the Form HUD 92264 and Line 3a of Form HUD 92264 A respectively.
- v. Upfront land lease payments essentially reflect the Net Present Value of annual payments that would have otherwise occurred under a Land Lease, subject to any/all HUD requirements. The appraiser must analyze that payment as it reflects the Net Present Value of the income stream that would have otherwise been an operating expense, thereby reducing the NOI. This up-front payment may also affect Leasehold Value as set forth in Criterion 3, potentially impacting the requested loan amount.

iv. The appraiser must support all Overall Rates, Discount Rates, Internal Rates of Return, etc. as it relates to the various components of Leased Fee and Leasehold Estate Values in the Market and clearly explain the impact on the Value Estimates. The Leased Fee value, may not exceed the Fee Simple Interest in the property, i.e. land, land and shell, land and building, etc.

F. Rehabilitation of an Existing Project (Building/ Improvements owned by the Tenant/ Borrower). When the Leasehold mortgage is to be insured and contains existing buildings the valuation processing shall be as follows:

- a. "As Is" Leasehold Value of both land and building(s) must be established by capitalization of income and/or by comparable sales, as appropriate.
- b. Value of the land without building/improvements must be made by market comparison based on sales of similar sites. When the existing improvements are in poor condition and have little or no inherent value, their contributory value may be added to the value of the site plus any demolition cost in order to render the structure ready for development.
- c. The total "As Is" is the value of entire project, is the value of the site plus contributory value of the improvements, plus any demolition costs, so that the site is ready and available for development. "

G. Maximum Mortgage Amount for Criterion 3. The value or replacement cost of the project described in the mortgage shall be the value or replacement cost of the Leasehold Estate (as determined by HUD), which in all cases shall be less than the value or replacement cost of the property in fee simple.

H. Fee-Joinders.

1. Under certain limited circumstances, HUD may insure mortgages even when the Borrower entity does not directly own the requisite Fee Simple Estate and/or eligible Leasehold interest with appropriate closing documentation to ensure compliance with the National Housing Act as discussed below.
2. Certain states have statutorily authorized programs that provide tax abatements to residential rental projects. In order to take advantage of such programs, private developers will transfer Fee Simple ownership of their project to the state or local development agency, and then enter into a Lease with the state or local development agency for a duration that is shorter than required under the National



Housing Act. Through a joinder to the FHA-insured mortgage, as an accommodation to gain FHA-insured financing, the governmental agency agrees to allow its Fee Simple Estate to serve as security for the FHA-insured loan. This arrangement is deemed a subordination of the fee (or “Joinder of the Fee”).

3. For FHA purposes, a document titled *Rider to the Security Instrument – Fee Joinder* (the “Rider”), must be used in these situations. Through this document, the governmental agency/Landlord agrees to subject its Fee Simple interest to the FHA-insured Security Instrument so that the MAP Lender has a first mortgage on real estate in Fee Simple for the entire term of the FHA loan. If the Borrower defaults under its obligations, then the FHA lender, HUD, or other purchaser at foreclosure sale (as applicable) will acquire Fee Simple title to the project.

4. MAP transactions requesting HUD approval for Joinder of the Fee must meet the following requirements:

- i. The project, Borrower, and transaction must otherwise be eligible pursuant to this MAP Guide;
- ii. The project must benefit from a state or locally authorized tax abatement program;
- iii. The Landlord must be a state or local unit of government or public entity created pursuant to state law;
- iv. Lender’s counsel and the HUD closing attorney must ensure that under state law, the FHA Security Instrument (mortgage or deed of trust) represents a first lien on the entire Fee Simple Estate of the project for the duration of the FHA-insured Note;
- v. The Rider must be executed and attached to the Security Instrument; and
- vi. Borrower must provide a title insurance policy satisfactory to the MAP Lender and HUD.

5. Valuation. Fee joinder structures must be underwritten to the full amount of the project taxes.

6. Additional Requirements:

i. Security Instrument.

1. The Landlord must be added to the first paragraph of the Security Instrument as an accommodating “Joinder Party.” This addition is necessary to ensure the proper indexing of the Fee Simple security interest granted by the Rider. While the Landlord will be added as a party in the first paragraph of the Security Instrument, it will not

- be a signatory to the Security Instrument itself.
2. The Rider must be executed by the Landlord and the Borrower and must meet the state-law specific signature and attestation requirements.
  3. The Security Instrument must not be referred to or titled as a Leasehold Mortgage/Leasehold Deed to Secure Debt/Leasehold Deed of Trust because the Rider results in the Security Instrument encumbering the entire Fee Simple Estate as collateral for the loan.
- ii. Title Insurance Policy.
1. The title insurance policy must not be a “Leasehold Loan Policy.” Instead, Schedule A2 must list both the Fee Estate and Leasehold Estate. Schedule A3 should similarly list both the Landlord and the Borrower. In Schedule A4, where the Security Instrument is listed, the Rider must be appropriately referenced. Schedule B, Parts I and II, must list all exceptions and encumbrances pertaining to both the Fee Simple and Leasehold Estates. Any exceptions must be acceptable to HUD.
- iii. *Lease Addendum – Multifamily*, form HUD-92070M.
1. The Borrower must use the Lease Addendum, striking paragraphs 7, 11, and 12, as they are not applicable in this Fee Joinder context. Further, paragraph 10 regarding condemnation must be stricken and replaced with the following (no HQ approval needed): “All awards and /or proceeds from the condemnation, or the negotiated sale in lieu of condemnation, of all or any part of the Tenant's and/or Landlord's interests in the Property, Improvements or the leasehold estate, shall be paid to Lender and applied as provided in the Security Instrument between Lender and Tenant.”

## **7.16 Tax Abatement Procedures**

- A. General Comments and Exceptions. Tax Abatement is a reduction of project taxes for a specified term by the taxing authority. Properties with abatement are eligible for additional mortgage funds under certain circumstances. The abatement must run with the real estate and not with the type of sponsorship if it is to secure additional mortgage proceeds based upon value (Criterion 3). The debt service approach (Criterion 5) used for underwriting must include an amount for the expected project taxes (including abatement or PILOT) in the

project operating expenses. The terms of the tax abatement must be analyzed and a stress test demonstrating the risk must be performed even if the present owner or its transferee may benefit from the abatement for the term of the mortgage. The risk that a transferee of the project or an assignee of the mortgage in the future might cause the tax abatement to be lost is an unacceptable risk to the insurance fund. Exceptions to these requirements include the following:

1. If the property is subject to low income housing tax credit covenants to maintain affordability or if over 90% of the units are covered by a Section 8 project based rental assistance contract, and if the tax abatement runs with the sponsorship (borrower) entity, then the Regional Center Director may waive the MAP Guide so that the underwriting does not have to include a provision for project taxes during the period of the tax abatement. This exception is justified for low loan-to-value mortgages on LIHTC projects and the additional due diligence and oversight by private equity investors. A real estate tax abatement will be recognized in both value (Criterion 3) and underwriting (Criterion 5) calculations even if the abatement runs with the owner rather than with the land, so long as the owner is non-profit sponsored.
  2. Properties leased from a governmental body to either a non-profit or for-profit developer, where the project is exempt from taxes and the abatement flows to the leasehold improvements. There is usually a requirement for a percentage of units to be set aside as affordable housing which is imposed by a land use restriction or regulatory agreement. Regional Center Directors may grant a waiver, after appropriate review, to promote affordable housing.
- B. Full Term Tax Abatement. If the amount of the tax abatement is fixed and runs the entire term of the mortgage, the real estate tax expense reported on the HUD-92264 must be the actual amount of taxes the project will pay, if any. The full amount of the real estate taxes without the abatement must be noted in the remarks section of the HUD-92264. The project will benefit from an increased mortgage amount due to the lower pro-forma operating expenses and an increased NOI estimate. When the abatement runs for the full term of the mortgage, the NOI used for Form HUD-92264-A Criteria 5 may also be processed at the actual tax amount.

Also, if value attributable to long term tax abatement is recognized in the subject's market area, the same NOI may be capitalized and the resulting value may be used in Criterion 3. Attributing value to the abatement is allowable only if the abatement is transferable.

- C. Partial Term or Variable Tax Abatement. If the abatement is partial term or variable, it may still be used to secure additional mortgage proceeds. The additional mortgage will be the amount that will amortize over the term of the tax abatement. A special amortization plan must be requested which has debt service payments that are increased by the additional net

income generated during the term of the abatement. When processing a partial term or variable abatement, the full amount of the project taxes must be estimated and included in the total project expenses on Form HUD-92264 as if there were no abatement. The additional debt service carry resulting from the abatement must be calculated on line I, Criteria 5 of HUD-92264-A.

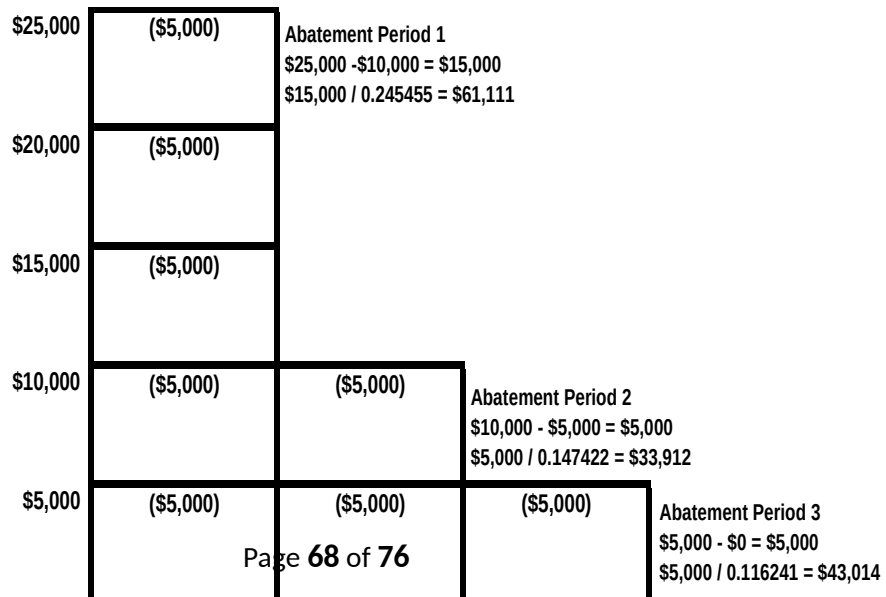
If Criterion 5, “Amount Based on Debt Service Ratio” is not the controlling criterion, partial term or variable abatements cannot be used to secure additional mortgage proceeds. Also, the appraiser must not include extra value associated with partial-term abatement in either the estimate of land value, the “As Is” value for substantial rehabilitation or the “As Repaired” or “As Is” value for existing projects, and it must not be included in Criterion 3.

1. Partial Term Abatements: Assume that Project A has been awarded a 5-year tax abatement of \$5,000/year and the interest rate on the insured loan is quoted at 7.5% and the MIP is 0.5%. The amount of additional mortgage is calculated by dividing the annual abatement, \$5,000 by the applicable debt service constant (P, I, and MIP). In this example the debt service constant is 0.245455383.

$$\$5,000 / .245455383 = \$20,370$$

Additional mortgage amount. The mortgage amount based upon debt service (Criterion 5 of HUD-92264-A) would be increased by \$20,370 and a special amortization schedule would be required with a debt service payment that is \$5,000/year greater in years 1 through 5.

2. Variable Abatements: Variable tax abatements are more complex to quantify but are essentially calculated in the same manner. Assume that Project B has been awarded 15-year tax abatement. In years 1 through 5, the abatement is \$25,000; in years 6 through 10 the abatement is \$10,000; and in years 11 through 15 the abated amount is \$5,000. The interest rate on the insured loan is quoted at 7.5% and the MIP is .5%. The amount of additional mortgage is calculated as the amount that could be fully amortized by the variable payments over the 15-year period based on the stated financing terms. The graph below illustrates the calculation.



When there are two or more abatement amounts and periods, and the amounts decline, the abatement amount for each period is found by subtracting the abatement amount of the next period. Period 1 will run for 5 years, Period 2 will run for 10 years, and Period 3 will run for 15 years. Because all three periods begin amortization at the same point in year 0, the amount of the abatement for the next period must be subtracted to avoid double counting.

i. Abatement Period 1

\$25,000 minus \$10,000 (the amount of abatement in period 2) = \$15,000 for 5 years. The debt service constant for a 5-year term at 7.5% interest with 5% MIP is 0.245455383. Dividing \$15,000 by 0.245455383 indicates additional mortgage proceeds of \$61,111 attributable to period 1.

ii. Abatement Period 2

\$10,000 minus \$5,000 (the amount of abatement in period 3) = \$5,000 for 10 years. The debt service constant for a 10-year term at 7.5% interest with 0.5% MIP is 0.147442123. Dividing \$5,000 by 0.147442123 indicates additional mortgage proceeds of \$33,912 attributable to period 2.

iii. Abatement Period 3

\$5,000 minus \$0 (since there are no periods remaining) = \$5,000 for 15 years. The debt service constant for a 15-year term at 7.5% interest with 0.5% MIP is 0.116241483. Dividing \$5,000 by 0.116241483 indicates additional mortgage proceeds of \$43,014 attributable to period 3.

iv. Adding the supportable mortgages from each of the abatement periods results in a total additional supportable mortgage of:

Period 1 = \$ 61,111  
Period 2 = \$ 33,912  
Period 3 = \$ 43,014  
Total = \$138,037

The mortgage amount based on debt service, (Criteria 5 of HUD 92264-A) would be increased by \$138,037 and a special amortization schedule would be required with a debt service payment that reflects \$25,000 per year in years 1 through 5, \$10,000 per year in years 6 through 10, and \$5,000 per year in years 11 through 15. The appraiser must not include extra value associated with variable abatement in either the estimate of land value, the “As Is” value for substantial rehabilitation or the “As Repaired” or “As Is” value for existing projects, and it must not be included in Criterion 3.

D. Deferral of Real Estate Taxes. A real estate tax deferral must be distinguished from a real estate tax abatement. A tax deferral only postpones the payment of real estate tax until some future date. The borrower shall not participate in a real estate tax deferral program unless approved by HUD Headquarters in writing. HUD will not approve participation in any real estate tax deferral program unless participation will not result in the creation of a lien that has priority over the insured mortgage and, if applicable, any second mortgage held by the Commissioner. However, if any deferred taxes result in a first lien on the property, the tax lien must be paid before HUD will allow an FHA insurance claim, and the payment will not be reimbursed by HUD as part of any insurance claim.

## **7.17 Project Based Section 8 and LIHTC Processing**

- A. For Section 223(f). The project must be evaluated under two scenarios: a) the “hypothetical market value” of the project without regard to any Section 8 project based subsidies, rent restrictions or LIHTC; and b) a debt service analysis that considers all Section 8 project based subsidies and other low income rent restrictions must be performed. Two independent Section C rent schedules must be prepared, one for a hypothetical market rent estimate and one that recognizes all rent restrictions and subsidies.
1. Criterion 3 Market Value: The appraiser must ignore the Section 8 contract rents, tax exempt bond or LIHTC restricted rents when determining market value and the income to be capitalized for a determination of market value for the purposes of determining Section K, Form HUD-92264, and Criterion 3 Form HUD-92264-A Value. To be consistent, the appraiser must use a market capitalization rate and must assume market rents in the income approach to value. Note that the comparable sales approach to value must be completed without regard to Section 8 or LIHTC awards.
  2. Criterion 5 Debt Service Analysis: In calculating net operating income to be used for Criterion 5 Debt Service, rent restrictions must be observed. For the Criterion 5 debt service analysis, the Line 6, Form HUD-92264-T rents must be used. This applies to projects receiving LIHTCs that may use either tax exempt bond or market-rate financing.
  3. Form HUD-92264T for LIHTC projects without Section 8: Follow existing form instructions. Processing will be based upon the lesser of Lines 1, 4 or 5.
  4. Form HUD-92264T for Section 8 Project Based Assistance without LIHTC:

- a. Enter the market rent by comparison on Line 1
- b. Enter Personal Benefit Expenses on Line 2
- c. Line 3 is Not Applicable
- d. Line 4 is Not Applicable
- e. Enter the Project Based Section 8 Contract Rent on Line 5
- f. Subtract Line 2 from Line 5 (if applicable)
- g. Process using the lesser of Line 1 or Line 5

5. Form HUD-92264T for Section 8 Project Based Assistance with LIHTC:

The LIHTC rent must be recorded but is not used as a limiting criterion because the total income to the project is the LIHTC rent combined with the Section 8 rent, so that the actual amount of rental income to the project will be the Project Based Section 8 rent, as follows:

|  |             |
|--|-------------|
| 2 Bedroom Section 8 Contract Rent      | \$850/Month |
| 2 Bedroom LIHTC Rent limit             | \$350/Month |
| Resident's Rent Obligation to Project: | \$350/Month |
| Section 8 Payment to Project:          | \$500/Month |
| Total Income to Project                | \$850/Month |

- B. Fee Income. If additional fees for project amenities are mandatory for all residents, the mandatory fee income from restricted units must be excluded from the calculation of net income. The mandatory fee income from non-restricted units may be included if these amenity fees are indicated by comparable properties in the market and it must be explained in the remarks section of Form HUD-92264.
- C. Income Limits. The HRA must ascertain that the correct income limits are employed in calculating the maximum LIHTC rents and in completing Form HUD-92264-T. HERA modified HUD's income limit methodology for calendar years after 2008 to require HUD to increase applicable area median incomes by the amount area median incomes rise, even if the HUD-determined area median incomes would be frozen under HUD's 2007 and 2008 income limit methodology.
- D. Expenses/Fees. Properties with LIHTC restricted units will commonly have a higher

operating expense ratio per unit than market rate properties, which may be due to increased administrative costs for tax credit compliance monitoring, performing resident income certifications and staffing to provide on-site resident services. Estimating operating expenses for projects that are to be funded through the sale of LIHTC, requires the analysis of LIHTC comparables if available, and consultation with other experts (i.e. appraisers and project managers) in the context of current market conditions which should consider the size of the project and unit mix. Utility expense unit rent adjustments in LIHTC projects may be estimated by the analysis of actual costs supplied by the developer, the utility company or by use of the Section 8 utility allowances.

1. If the project has the same operating expenses under LIHTC or Project Based Section 8 operation as it would under market rate operation, enter expenses as usual.
2. If a project has different expense needs as a subsidized project, the expenses used for Criterion 3 must be market rate expenses and the expenses used for Criterion 5 debt service shall be the actual expenses under it's proposed usage. This will insure that the Criterion 5 - debt service analysis of the HUD 92264a is calculated based on the actual estimate of the rent restricted NOI for the project.

## **7.18 Appraisal Review Policy and Requirements**

### **A. Scope of Work.**

1. Scope of Work includes project identification, extent of inspection, the type and extent of data researched, and the kind of analysis needed to arrive at opinions or conclusions. The rule also states that appraisers have broad flexibility and significant responsibility in determining the appropriate scope of work for an appraisal or appraisal review assignment.
2. According to USPAP, appraisers, including HRAs are responsible for determining the scope of work. However, as an employer who is also the client, the Department may issue guidance as to what is the extent of an assignment for a review appraisal. It is not a violation of USPAP for an appraiser to accept an assignment, in which a limited scope of work is appropriate, so long as the assignment and scope of work are clearly defined, produces credible results and is performed objectively without bias.
3. HRAs may have to expand the scope of work and do additional research in performing an assignment. The HRA should discuss such situations with management in order to determine whether additional work by HUD staff is appropriate, or if the application should be rejected or approved with conditions.



4. According to USPAP, if relevant information is not available because of assignment conditions that limit research opportunities (such as conditions that place limitations on inspection or information gathering), an appraiser must withdraw from the assignment unless the appraiser can still develop credible assignment results. For example, they may be able to modify the assignment conditions to expand the scope of work to include gathering the information or use an extraordinary assumption.

#### B. Jurisdictional Exception Rule.

1. The Jurisdictional Exception Rule provides a saving or severability clause intended to preserve the balance of USPAP if compliance with one or more of its parts is precluded by the law or regulation of a jurisdiction. When an appraiser properly follows this Rule in disregarding a part of USPAP, there is no violation of USPAP.
2. USPAP defines law as including constitutions, legislative and court-made law, administrative rules and ordinances. Regulations include rules or orders having legal force, issued by an administrative agency, such as HUD. This would include Handbooks, Notices, and the MAP Guide. Instructions from an attorney or a client do not establish a jurisdictional exception.
3. The need to take a Jurisdictional Exception should be rare. If it is needed, the appraiser or HRA must specifically cite the regulation and the portion of USPAP that is affected. Verbal direction from management is not sufficient to justify an exception. The HRA must cite a citation from the MAP Guide or other appropriate authority.

C. Record Keeping Rule. This rule specifies record keeping procedures for appraisers. The rule does not mandate that an appraiser have possession of assignment work-files. The Department does not permit permanent or personal possession of records relating to a review appraiser's work. The Department retains these records for far more than the time required under USPAP and will, with due process of law, cooperate with appraiser regulatory agencies, professional peer review committees, and to assist obtaining a professional designation. Appraiser work-files will be maintained in the Satellite office. When an HRA leaves employment, they shall be transferred to the Regional Office. Records should be stored on the local or regional network drive. Paper records should be scanned as needed.

D. Loan Committee. HRAs are expected to complete workload assignments to facilitate loan approval (or rejection) including an executive summary and other material needed for

Regional Center or National Loan Committees. The summary is intended to allow peers and management the ability to efficiently complete their reviews and conclusions. The Department allows the use of an alternative format for the NLC narrative as long as it is approved by the Regional Center Director and contains an executive summary. It is the Department's position that its programs and instructions are in compliance with USPAP. Management has the right to disagree with conclusions made by HRAs or any other technicians. Management should document the file with the reasons for any disagreement. The original conclusions are part of the permanent project file.

- E. **Workload Sharing.** Workload Sharing arrangements may require HRAs to perform reviews without the benefit of being able to do a physical inspection. The assignment will generally be completed with the HRA making certain assumptions, such as the condition to be consistent with the photographs and other reports.
  
- F. **Consultations with other staff.** HRAs may be required to provide consultation with senior underwriters and other staff who have been asked to review an appraisal. A Frequently Asked Questions grid included in Addendum 7 that discusses tasks which can be accomplished, as well as the level of required USPAP compliance.
  
- G. **Environmental Processing.** The responsibility for environmental processing has been typically assigned to the HRA, though other appropriately trained HUD staff may also perform these reviews. In accordance with 24 CFR 50.32, HUD, not the lender, is responsible for independently evaluating the information supplied by the lender, supplementing that information as needed, and making the required findings in HEROS as the environmental review record for the project. HUD will determine whether the proposed project site is out of compliance with applicable laws, Executive Orders, or regulations or otherwise would endanger residents' health or safety or put FHA mortgage insurance or the US Government at financial risk or liability. Federal regulations at (24 CFR 50.11) further require that a Program Approving Official, take responsibility for the scope and content and the environmental finding. These functions cannot be delegated to a lender or the lender's or owner's consultants. In order for HUD to complete these functions, the lender or lender's consultant must submit an environmental report to HUD using the HEROS system for all projects submitted under MAP. Additional details provided in Chapter 9 of this guide.
  
- H. When HUD staff appraisers are assigned this duty, it is not considered an appraisal assignment subject to USPAP requirements. In accordance with Chapter 9 of this Guide, the Department expects the appraiser or other responsible staff to perform the environmental review under the National Environmental Protection Act (as required), HUD's regulation at

24 CFR Part 50, and ensure compliance with related environmental laws and authorities, including the Wetlands/Floodplain Executive Orders, Endangered Species Act, National Historic Preservation Act , etc. HUD staff must review the HEROS report, including the Phase I Environmental Site Assessment submitted by the Lender and obtain additional information as needed from other governmental or private sources, and complete the review in HEROS. The Regional/ Satellite Director who issues the commitment is responsible for certifying the review in HEROS as the Program Approving Official. Chapter 9 requires that HUD staff must make a site visit.

- I. Technical Appraisal Review Requirements. The HRA or senior underwriter must follow the review requirements listed below:
  1. Exhibits. The lender must submit the exhibits listed in Section 7.10.A to HUD.
  2. Market Study Review. The HRA or senior underwriter and the EMAD economist must each provide a desk review of the market study to determine reasonableness and compliance with Market Study requirements. The Reviewer must make final recommendations to the team leader regarding market demand for the project.
  3. Level of Inspection. The HRA or senior underwriter must state the level of inspection. Preferably they should inspect the subject site and as many as possible of the comparables used in the appraiser’s forms HUD-92273 and HUD-92274 analysis.
  4. Environmental Review. The HRA (or other designated employees) must review the lender’s submitted HEROS report, including the Phase I ESA, supplement the information as needed and make the required findings in HEROS.
  5. The HRA must review site characteristics and make a recommendation regarding site acceptability to the team leader.
  6. The HRA must determine that the comparables submitted are acceptable.
  7. From a review of Forms HUD-92264, HUD-92273, HUD-92274, and supporting information, the HRA must make a recommendation to the team leader regarding:
    - a. The acceptability of the proposed rents and estimated rental income.
    - b. The acceptability of the total operating expenses.
    - c. The acceptability of the site and the estimated warranted price of land or “as is” value.
    - d. If applicable, the estimate of market value.

- e. Any recommended modifications necessary to approve the application instead of a categorical rejection. Any value conclusions made by HRA that differ from the appraisal under review require preparation of a work file in accordance with Standard 1 of USPAP. Only licensed appraisers may develop a different value. In determining acceptability, the Department prefers that the HRA or senior underwriter only opine on the quality of the work under review and as to whether or not it is reliable for use in underwriting mortgage insurance.
- 8. Compliance with USPAP. The HRA or senior underwriter must also ascertain if the appraisal complies with Standards 1 and 2 of the Current USPAP. Senior underwriters must be familiar with USPAP or consult as necessary with the HRA. USPAP does not require that reviews to determine USPAP compliance be made by an appraiser.
- J. Documentation of the Appraisal Review. The Department's SharePoint site contains a number of appraisal review templates as well as review forms from the previous MAP Guide. HRAs and senior underwriters have a great deal of flexibility in the format that they use, so long as it is approved by the Regional Center Director and contains an executive summary.