September 1, 2013

Memo:

To: Chris Austin
Scott Farmer
Mark Shelburne
A. Robert Kucab
North Carolina Housing Finance Agency
Low-Income Housing tax Credit Allocation Committee

From: Thomas W. Urquhart
Urquhart Development, LLC

RE: 2014 Qualified Allocation Plan for the 2014 Allocation of Low-Income Housing Tax Credits

As evidenced by the number and quality of applications in recent years, the previous Qualified Allocation Plans (QAPs) for the allocation of Low-Income Housing Tax Credits (LIHTC) have been very workable documents. Changes, however, to the LIHTC industry will require changes in the existing document and as well as changes which will make a future QAP produce better housing for the long term. There are also changes which may make the QAP clearer and easier to understand and changes to disqualifying sites that should be modified.

Looking back, the QAP for 2012 and 2103 concentrated too much on the amount of LIHTC per unit. Effectively, this tie breaker was the determining factor for the allocation of LIHTC for the majority of the applications. The LIHTC/unit measurement may deter high quality affordable housing projects that are designed and built to be a long term asset for their communities.

The policy's goal is to maximize the number of units produced by the annual allocation. This is laudable but not at the expense of poorly designed, built and managed projects. It rewards the developers who can bring additional unusual addition financing sources to their application and this should be supported.

The concentration on the lowest amount of LIHTC per unit may be causing unintended consequences. It adds an incentive to developers to cut back on the quality of their projects, reducing the total costs and, therefore, the amount needed in LIHTC. Making the LIHTC per unit the primary tie-breaker gives the developers an incentive to cut construction costs estimates, lower expected operating expenses and increase the projected income for an application. It is very difficult for a developer to know when the projections have crossed the line.

The impact of these consequences may result in projects with significant problems. A possible problem is underestimating the construction costs. Reduction of construction costs estimates below the actual costs results in poorly built and late delivered projects, sometimes costing more than they would have had a more accurate construction cost estimate been used. A project developed with a construction budget that is too low will be a project that is difficult to rent and manage. It will also have higher ongoing maintenance expenses. The consequences of overestimating the income and underestimating the expenses result in poorly operating projects and projects with significant management issues due to the lack of funds for the operations including on-site salaries. Quality that is too low results in harder to rent complexes and future higher operating expenses.

Projects with poor underwriting will not be good real estate deals and therefore cannot be a good LIHTC project. I believe that the previous QAPs from the late 1990s and early 2000s did result in some projects which have had significant problems due to poor underwriting, which were unintentionally encouraged by the QAP. Certainly the primary blame for poorly underwritten, built and performing project lies with the developer, but the QAP should not reward poor underwriting.

All of the three potential consequences in underwriting mentioned above are problems the NCHFA has seen in previous LIHTC projects. The lack of quality construction has resulted in LIHTC projects built only fifteen to twenty years ago needing significant renovation well beyond what would have been required had more they had been properly funded and constructed.

The concentration on the least amount of LIHTC per unit may be slightly unfair to certain projects, penalizing projects with more units with 3 or more bedrooms in many counties in North Carolina. Conversely, my calculations show that the amount of LIHTC needed per unit is actually higher for projects concentrating on seniors in most counties. This is a result of the lower amount of mortgage that each unit can sustain. In most North Carolina counties the amount of the mortgage placed on a senior's project is so much lower than a family project that the amount needed from the LIHTC equity per unit is higher. I was surprised by this outcome.

If we continue to use the lowest amount of LIHTC per unit as the tie breaker or as point category then I suggest adding an additional category of the amount of LIHTC per bedroom. This results in two tests similar to what Virginia does in its QAP. It would have the effect of more closely measuring the LIHTC provided per person helped. There could also be changes to the formula which does not punish the higher cost projects such as townhouses, duplex, single family and Historic Credits projects. Another change to the formula might be needed to make projects for seniors more competitive.

Please remember that a poor real estate deal cannot be a good LIHTC project. A good LIHTC project has to be a good real estate deal.

There are other aspects of the QAP that require review. The limiting of one project to a county (except Mecklenburg and Wake) has a laudable goal of spreading the LIHTC to more counties. It, however, may result in an overall reduction of the quality of the projects. It also does not seem fair for those counties with large populations such as Guilford, Forsyth, Cumberland, etc. Yes, Guilford County only has 53% of the population of Wake County, but it still has in excess of 500,000 people. Perhaps a policy that allows two allocations for counties with populations greater than 300,000 (Guilford, Forsyth and Cumberland) or for populations greater than 200,000 (adds Durham, Buncombe, New Hanover, Union and Gaston).

I worry about the effects of the now rising inflation in the cost of building the projects. I am very concerned that the contingencies allowed in the projects budgets will not be sufficient to cover the additional costs caused by inflation. I also think that the current per unit maximum costs before negative points are assigned should be increased.

I am a big fan of the NC LIHTC loan program and hope that we can convince the General Assembly to continue it. The program makes many projects financially feasible and helps families with low incomes.

In addition, the placement of which counties are in the low, moderate and high income categories could use some refining. There are some counties in the high and moderate income categories which need more assistance than the current procedure allows. These counties are those with the lowest Area Median Income for their income category. There are some 2013 Moderate Income Counties for which the it appears the 2104 rents will be based on the minimum amount allowed in the program. This means that the AMI for this county is less than the median income for all non-metropolitan counties in the US and have maximum rents less than some counties in the low income category. It will be very difficult to make a project in these counties financially feasible in 2014 without the maximum 30% NC LIHTC loan.

The consequences of Congress allowing the 9% credit rate fall form it current fixed rate of 9% needs to be covered in the 2014 QAP. The result may inject many problems and will eliminate many counties from having projects that are financially feasible. It will also reduce the areas inside a county where a project may be feasible by either requiring the project to be in a QCT for some counties or not in a QCT for other higher income counties. I am not capable of proposing a policy that will eliminate the effects of this change, but I do think that the QAP should continue to have language built in for this event. The QAP may need language which allows the NCHFA grant any project the maximum 30% basis boost. This would boost the number of counties in which a LIHTC project could be developed.

With regard to specific provisions in the current QAP:

- There should be an increase in the minimum annual costs to operate the projects. More metropolitan areas have higher employment costs and typically higher other costs, but this effect is not universal.
- The language in II (A) is slightly inconsistent with the language at II (G). The first could be interpreted as an absolute limit of 10% for renovation projects but the second would seem to allow more allocations to renovation projects if credits were available after funding new construction projects.
- In II (D)(2) the language "excluding mortgage subsidy" is no longer needed since there are no mortgage subsidy points.
- The portions of the QAP that deal with new project based subsidy are also slightly inconsistent. In IV (B)(1) and VI(B)(6)(d) make a project ineligible if a proposed project based subsidy is not granted. However VI (B)(13) indicates that the rents used for underwriting will not be based on the rents in the proposed project based subsidy. Why make a project ineligible for something that does not affect the underwriting?
- The required Debt Service Coverage Ratio for years 19 and 20 in the proforma is confusing. The requirement in VI (b)(1)(b) requires a 1.15 to 1 DSC through year 20, but VI (b)(6)(a) allows for a permanent loan balloon payment at the end of year 18. If we assume a balloon payment then years 19 and 20 have no debt service and no DSC. Calculations show that a hypothetical project in a moderate income county, the initial rents on the units affordable at 60% of AMI will need to be approximately $7 more per month if the required DSC of 1.15 is at year 20 rather than at year 18.
- The minimum operating reserve of $1,500 per unit is less than the minimum required by the formula. Removing the minimum or increasing it to match the formula. I understand that bond deals only have to have 4 months expenses and debt service per unit but this will always exceed the $1,500 minimum. Perhaps the minimum should be reset at $1,800.
- Negative points should be removed for electrical utility substation and power transmission lines and towers. The negative points for distribution facilities and

factories should be revised to reflect the potential problems caused by the facility. A facility operated for only the day shift with minimal unpleasant environmental or other effects should not result in negative points.

Thank you for the very good work you have done in the past, and I look forward to working with you in the future.