SINGLE FAMILY DEVELOPMENT

Agenda – April 1

- Introductions
- Background of class participants
- Ground rules
- Course outline and objectives
- The single family crisis
- Single family versus multifamily development
- Underwriting single family developments
- Construction financing options
- Down payment assistance programs
- Non-traditional forms of homeownership
- Break
- Questions from first-half of session
- Case study presentation
- Case study loan analysis
- Case study changes to original pro-forma
- Summary and closing/Questions

Introduction

- Homeownership supports the health and diversity of our communities
- Single family “for-sale” development has been challenged since the mortgage crisis began in 2007
- Development in today’s environment presents unique challenges for lenders and developers

Overview

As a result of this course, you will be able to:

- Underwrite a single family development
- Understand market versus affordable single family development
- Understand construction financing options
- Understand down payment assistance programs
- Understand the risks of single family development
- Understand non-traditional forms of homeownership

Glossary

- **Loan-to-value ratio:** A percentage calculated by dividing the amount borrowed by the price or appraised value of the home to be purchased; the higher the LTV, the less cash a borrower is required to pay as down payment.
- **Loan-to-cost ratio:** A percentage calculated by dividing the amount borrowed by the cost to develop the project.
- **Appraised value:** An estimate of a property's fair market value.
- **Pro-rata Loan Amount (also called "PAR" Value):** Calculated by dividing the loan amount by the number of units of inventory.
- **Release multiple:** The factor by which you multiply the prorate loan amount to derive the release price.
- **Release price:** The dollar amount required by the lender to release its lien on the subject collateral.
- **Hard costs:** Included in hard costs are all of the costs for the visible improvements, line items like grading, excavation, concrete, framing, electrical, carpentry, roofing, and landscaping . Another way to describe hard costs are the "brick and mortar" expenses.

- **Soft costs:** Soft costs may include the following: architect's fees, engineering reports and fees, appraisal fee, toxic report fee, government fees, building permits, assessments, sewer and water hook-up fees, construction period interest and loan fees.
- **Gross profit margin:** Calculated by subtracting the cost to build the home from the sales price.
- **Developer Fee:** The amount in the development budget that the developer is paid to develop the project.
- **First-time homebuyer:** There are different definitions depending on funding source, but often it is a household that has not owned a home in the previous three years.

- **WISH:** FHLB program to provide down payment assistance to first-time homebuyers. The lender provides the money at time of closing and is reimbursed by FHLB. Matching program at a 3:1 ratio for the homebuyer.
- **HOME:** Federal program that is operated by states and/or local governments to provide down payment assistance to first time homebuyers.
- **Subdivision improvements:** All of the local jurisdiction required work that is not directly related to individual home construction: i.e. roads, curbs, gutters, sidewalks, common area landscaping, etc.
- **Silent Seconds:** Funds offered by a lender or other entity that does not require repayment until the home is resold.
- **Self-Help Housing:** Most often found in rural areas and often funded by USDA-Rural.

How is single family the same as multifamily?

- **They are residential properties**
- **Market Demand is influenced by**
  - – Population growth (job growth)
  - – Income Levels of the families
- **Loan Budgets include**
  - – Land cost
  - – Construction Costs
    - Material
    - Labor
  - – Financing Costs
  - – Other Soft Costs

How is single family different from multifamily?

Multifamily

- How much will the units RENT for?
- What size term loan(s) can be supported by this rental income?
- The developer generally earns his/her developer fees during construction and/or later as “earn-out” from property cash flow

Single family

- What will the SALE prices be?
- What size mortgage can each home buyer qualify for based on his/her income?
- The developer earns his/her developer fee from the profit margin on the sales of the individual units

Differences Cont.

Multifamily

- The entire interim financing is generally repaid at one point in time
- The interim loan's source of repayment is a commercial term loan
- The term lender's source of repayment is the NOI on the property

Single family

- The interim financing is usually paid incrementally as each home sale closes
- The interim loan's sources of repayment will be the consumer mortgage loans made to the home buyers
- The term lender's sources of repayment is the consumer's income

Differences Cont.

Multifamily

- Outside of developer fees on projects under construction, a developer's portfolio can be a source of "recurring" cash flow as shown below

  Equation

  Rent

  <Vacancy>

  = EGI

  <Op Exp>

  <RR>

  = NOI

  <Debt Service>

  = Cash Flow *after debt service*

Single-family

- The Single Family developer's cash flow is generally not considered recurring in this same sense; homes must continue to be built and sold profitably in order for the developer to continue generating cash flow

  Equation

  Sales Price

  <Cost to Build> *"Costs of Goods Sold"*

  = Gross Profit

  <Sales Closing Costs>

  = Contribution Profit

  <Overhead>

  = Net Profit

What are the key components to underwriting single family homes?

- Experience and Capacity of Developer
- Property Valuation
- Property Condition
- Project Economics
- Market Economics

Experience and Capacity of Developer

- Credit rating
- Track record
- Market knowledge
- Product knowledge
- Financial strength (net worth and liquid assets)
- Support staff

Property Valuation

- Appraised Value
- Loan-to-value/Loan-to-Cost Ratios
- Comparables
- Other
  - Monthly absorption (lot and homes)

Property Condition

- Environmental issues
  - Hazardous materials
  - Wetlands
- Site development
  - Grading
- Accessibility to utilities and roads

Property Economics

- Budget
- Sources of Equity
- Projected Profitability and Cash Flow
- Loan Structure and Repayment
- Construction Contract
- Local Labor Market

Market Analysis

- Market Study
- Defining the market area
- Competition
  - Affordable versus market rate housing
  - Multifamily market
- Demand analysis
  - Demographic trends

How do you find qualified homebuyers?

- Market demographics
  - Affordable versus market rate housing
  - Marketing to Housing Authorities
  - Market to Human Resource Departments of large corporations
- First-time homebuyers
- Down-payment assistance programs
- Pre and post-homebuyer training programs

Construction Financing Options

- Use an aggregate loan sizing with defined “start” limitations
  - $2,000,000 loan to build 20 houses of $100,000 each
  - Have a clause in Loan Agreement which limits the maximum number of houses allowed at any given time to 10 houses
- Use a revolving line of credit
  - $1,000,000
  - Each loan for each house will equal $100,000
  - Therefore, you can have 10 houses under construction at any one time

Bank Requirements

- Guarantees
- Loan Covenants
- Pricing
- Terms

Down-payment Assistance Programs

- HOME and WISH
- How will programs impact development
  - Income restrictions (set-asides)
  - Repayment
  - Liens

Non-traditional Forms of Homeownership

- Low-income Housing Tax Credit Program
  - Highly competitive
- Self-help
  - Usually USDA Rural Development program but also urban programs
  - Eligible areas - <25,000 population

Sunrise Homes, LLC

Case Study Presentation - Facts

- **Sponsors**

  Sunrise Homes, LLC is a limited liability company formed by four members who share a more than 10-year history of working together to develop affordable housing. One of the members is a nonprofit 501©(3) corporation that was started in 1988 to develop affordable housing for low-income families. As part of its mission, the organization offers training and down-payment assistance for low-income first-time homebuyers. The other three members have significant multifamily affordable housing experience, which includes development, property management, fair housing, and consulting. The financial statements and tax returns provided by the individual members of the limited liability company reveal that there is sufficient net worth and liquid assets on a combined basis to satisfy the Bank’s underwriting criteria.

  This will be the first single family development undertaken by Sunrise Homes, LLC.

- **BACKGROUND**

  In 2004, the members of the LLC decided to provide first-time homebuyer opportunities for low-income households through the development of a 46 single-family home subdivision. This decision was supported by the local HOME Consortium staff, the City Council member representing the area, and various lenders who wanted to be involved in single-family homeownership. The members identified a 9.5 acre parcel of land for sale in a growing area of the City, which was also close to the University, the freeway for commuters, and only 2 miles from many of the major employment sources in City. After all due diligence on the parcel was completed (phase I environmental report, geotechnical report, appraisal of the land and initial conversations with City staff regarding potential development conditions), the parcel was purchased and funds for down-payment assistance were obtained from the local HOME Consortium.

- **THE DEMAND**

  In 2004, the prices of single-family homes had increased in one year by almost 20%. There were no homes available and affordable to households earning 80% of area median income or less. While down payment assistance programs were available, the price of housing had escalated so much that the assistance was insufficient to allow low-income first-time homebuyers to enter the market. By 2005, sales prices were continuing to increase and even moderate-income households could no longer purchase a home. Initially, the subdivision was to have 30 affordable homes restricted to those earning 80% AMI and below with 17 market rate homes which would help subsidize the affordable homes.

- **LOCATION**

  The project site was a vacant 9.5-acre parcel located in northeast part of the City with immediate access to both Highway 45, the main north-south corridor in the City and North Carolina Street, a main transit oriented corridor which feeds into the Ring Road around the City and the University. The location promised to reduce commute times as well as transportation costs to households who were buying homes as much as 45 miles outside of the City for affordability purposes.

- **PROJECT DESIGN**

  The project is a single-family subdivision with small, individual lots and a combination of a main public street that traverses the entire subdivision and supports the individual hammerhead, private streets. There is a mix of single-story and two-story homes, three-and four bedroom homes and six different elevations to provide visual contrast in the subdivision. There is a common area lot with landscaping and mailboxes. The views of the mountains from the homes are spectacular.

- **PROJECT AREA CALCULATIONS**
  - Site Area: 9.5 acres
  - Lot Size Range: 5,000 square feet to 9,500 square feet
  - Average Lot Size: 6,000 square feet
  - Two-Bedroom Homes: 1,450 square feet
  - Three-Bedroom Homes: 1,625 square feet
  - Total Square Footage: 70,950

- **SOURCES OF EQUITY AND FINANCING**

Total cost of the project to date is approximately $9.1 million including interest cost and other carrying costs while homes are unsold. Financing for the cost of the land and water rights ($1,200,000) was provided by a regional Community Development Financial Institution, a nonprofit lender. This loan has stayed in the deal until all of the homes are sold at a subordinate position. The subdivision improvements and home construction loan was provided by a local bank a total of about $7.1 million. All of the equity for carrying costs and cost overruns has been provided by the members of the LLC and totals about $802,000 to date. Down-payment assistance has been provided by a combination of HOME funds from the HOME Consortium, ABC Bank silent seconds, and WISH funding from the Federal Home Loan Bank. Fannie Mae made a predevelopment loan to the nonprofit member of $250,000, which was used by the LLC to pay predevelopment costs. That loan was repaid with interest at the start of construction by the a loan from the local bank.

- **FINANCIAL ANALYSIS AND ECONOMIC OUTLOOK**

  Due to the spectacular occurrence of three different events during the development of this project, the outlook for this project is not a positive one. Prior to construction, the local water authority ran out of water rights and the price of those available increased by tenfold. Waiting for the water rights caused the start of the subdivision improvements to be delayed by five months and further caused those improvements to be built over the winter, which resulted in further delay. By the time the first homes will ready for sale, the bottom had dropped out of the sub-prime market, which caused many of the homebuyers to become ineligible for financing due to stricter underwriting standards. When the final homes are sold, hopefully sometime in 2008, the project will have produced about 12 homes restricted to low-income, first time-homebuyers and 34 market rate homes. Although, the project didn’t meet its numerical goals, the reality is that most of the market rate homes were sold at the same price as the affordable ones and mostly to first-time homebuyers with moderate incomes. With the sponsor’s capital injection of $802,000, the net profit will be approximately $400,000 instead of the projected $1,200,000.

- **PROJECT SCHEDULE AND KEY MILESTONES**
  - Land Acquisition: April 2005
  - Water Rights Acquisition: October 2005
  - Subdivision Improvements Started: December 2005
  - Subdivision Improvements Completed: September 2006
  - First Homes Started Construction: August 2006
  - First Homes Completed: March 2007
  - All Construction completed and approved by City: November 2007
  - Total Homes Sold to Date (February 2008): 33
  - Homes Remaining to Sell: 14

Case Study Questions

1. What size loan will the borrower need for the acquisition and development loan?
2. What will be the release price for the individual lots?
3. When is the bank repaid?
4. What size loan will the borrower need for the vertical construction loan?
5. What will be the release price for the individual houses?
6. When is the bank repaid?
7. What will the loan to cost ratio be for each house?
8. What will the loan to value ratio be for each house?
9. What will be the borrower's cash flow for each house?
10. What about in the aggregate?
11. What will be the borrower's contribution profit for each house?

Sunrise Homes Budget

BUDGET CATEGORIES	TOTAL	LOAN	CHANGES TO BUDGET	EQUITY
LAND	$2,195,000	$995,000		$1,200,000
HARD COSTS				
Site Work	$400,000	$400,000		
Residential Buildings	$4,000,000	$4,000,000	$300,000	$300,000
Contractor Overhead and Profit	$484,000	$484,000	$30,000	$30,000
Hard Cost Contingency	$244,200	$244,200		
Sub-Total Hard Costs	$5,128,200	$5,128,200		
SOFT COSTS				
Bank Loan Fee	$61,255	$61,255	$25,000	$25,000
Bank Interest Reserve	$203,855	$203,855	$192,000	$192,000
Bank Legal Fee	$5,000	$5,000		
Subordinate Lender Interest Reserve	$46,000	$46,000	$69,000	$69,000
Subordinate Lender Legal Fee	$5,000	$5,000		
Bank Inspections	$10,000	$10,000		
Borrower's Legal and Accounting Fees	$10,000	$10,000		
Architectural Design	$75,000	$75,000		
Architectural Inspections	$25,000	$25,000		
Testing	$20,000	$20,000		
Permits and Fees	$329,000	$329,000	$100,000	$100,000
Construction Period Property Taxes	$7,500	$7,500	$32,000	$32,000
Title/Escrow and Closing	$20,000	$20,000		
Construction Insurance	$75,000	$75,000		
Marketing	$50,000	$50,000		
Consultant	$50,000	$50,000		
Assessments			$30,000	$30,000
Utilities			$24,000	$24,000
Soft Cost Contingency	$20,000	$20,000		
Sub-Total Soft Costs	$1,012,610	$1,012,610		
TOTAL DEVELOPMENT COSTS	$8,335,810	$7,135,810	$802,000	$2,002,000

Lot Development Loan

SOURCES:	TOTAL
Bank Loan	$1,395,000
Total Sources	$1,395,000
USES:	
Pay off Land Loan	$995,000
Site Work	$400,000
Total Uses	$1,395,000

Lot Release Price

- Release price per lot for Sunrise Homes:
- Release multiple = 1.25x
- Release price per lot = $1,395,000 (loan amount)/46 (lots) x 1.25 = $37,908
- When does the A & D loan get repaid? 46 lots/1.25 = 36.80 Houses

Vertical Construction Budget

SOURCES	TOTAL
Bank Loan	$7,135,810
Sponsor Equity	$802,000
TOTAL SOURCES	$7,937,810

USES	TOTAL
Pay off A & D Loan	$1,395,000
Hard Costs	
Residential Buildings	$4,300,000
Contractor Overhead and Profit	$514,000
Hard Cost Contingency	$244,200
Sub-Total Hard Costs	$5,058,200
Soft Costs	
Bank Loan Fee	$86,255
Bank Interest Reserve	$395,855
Bank Legal Fee	$5,000
Subordinate Lender Interest Reserve	$115,000
Subordinate Lender Legal Fee	$5,000
Bank Inspections	$10,000
Borrower's Legal and Accounting Fees	$10,000
Architectural Design	$75,000
Architectural Inspections	$25,000
Testing	$20,000
Permits and Fees	$429,000
Construction Period Property Taxes	$39,500
Title/Escrow and Closing	$20,000
Construction Insurance	$75,000
Marketing	$50,000
Assessments	$30,000
Utilities	$24,000
Consultant	$50,000
Soft Cost Contingency	$20,000
Sub-Total Soft Costs	$1,484,610
TOTAL USES	$7,937,810

Release Price for Homes

- Release multiple = 1.10x
- Release price per lot = $7,135,810 (loan amount)/46 (lots) x 1.10 = $170,639
- When is the Bank loan repaid in full? 46 Homes/1.10 = 41.82 Homes

Cash Flow Summary

Individual Home Cash Flow

Sales Price	$218,000
Less Bank Loan Repayment	$155,126
Less CDFI Loan Repayment	$26,087
Gross Cash Flow Per Unit	**$36,787**
Less Sales Costs	$8,720
Net Cash Flow Per Unit	**$28,067**

Cash Flow for all 46 Houses
$28,067 x 46 = $1,291,070

Less Sponsor Capital Injection = $802,000

Net Cash Flow = $489,070

Profit Summary

Equation

Sales Price	$218,000	
<Cost to Build> *"Costs of Goods Sold"*	$175,781	(Initial Budget Less Carrying Costs - Interest Reserve)
Gross Profit	$42,219	
<Sales Closing Costs>	$8,720	(Closing Costs - 4% of Sales Price)
Contribution Profit	$33,499	
<Overhead>	$5,432	(Carrying Costs - Interest Reserve)
Net Profit	$28,067	

Anticipated Profit Summary for Sunrise Homes

Sales Price	$10,028,000	($218,000 X 46 Homes)
<Cost to Build> *"Costs of Goods Sold"*	$8,085,955	(Initial Budget Less Carrying Costs - Interest Reserve)
Gross Profit	$1,942,045	
<Sales Closing Costs>	$401,120	(Closing Costs - 4% of Sales Price)
Contribution Profit	$1,540,925	
<Overhead>	$249,855	(Carrying Costs - Interest Reserve)
Net Profit	$1,291,070	
Less Sponsor Capital Injections	$802,000	
Revised Profit Summary	$489,070	

Summary and Conclusions

- Unforeseen challenges
  - Sub-prime market
  - Increased construction costs
  - Competition for resources (water rights)
- Mitigating Factors
  - Financial strength of sponsors
  - Track record of sponsors
  - City and County support for development
  - Relationship with construction and subordinate lenders