Enterprise®

Early Warning Systems for Affordable Housing Properties: Identifying and Communicating Property Risk

from the series **Building Sustainable Organizations**

By Ben Nichols and My Trinh

About Enterprise

Enterprise is a leading provider of the development capital and expertise it takes to create decent, affordable homes and rebuild communities. For 30 years, Enterprise has introduced neighborhood solutions through public-private partnerships with financial institutions, governments, community organizations and others that share our vision. Enterprise has raised and invested more than $11 billion in equity, grants and loans to help build or preserve nearly 300,000 affordable rental and for-sale homes to create vital communities. Visit *www.EnterpriseCommunity.org* to learn more about Enterprise's efforts to build communities and opportunity.

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Introduction

In February 2011, Enterprise released *Building Sustainable Organizations for Affordable Housing and Community Development Impact: Lessons and Recommendations from the Field*. The report – based on a review of 10 nonprofit organizations that failed or nearly failed in the past five years – offered recommendations for strengthening community-based development organizations.

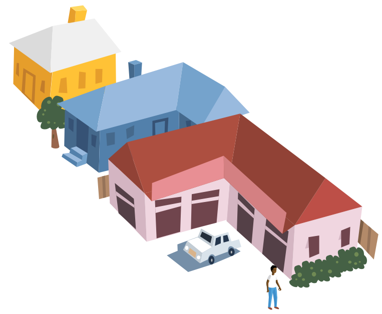
A key recommendation of that report advised housing developers and their funders to adopt an early warning system to identify emerging property-related fiscal and operational issues, and seek assistance in addressing them. At the heart of this recommendation is the need for housing development organizations to become more risk-aware, and for funders to become more open to providing early assistance to avert crisis.

As a follow-up to that report, *Early-Warning Systems for Affordable Housing Properties* provides guidelines for developing an early-warning system. These suggestions are not designed to discourage organizations from risk-taking, but to help a developer's board of directors and senior management recognize and manage the risks of development and long-term property ownership. A small group of strong organizations has used early-warning systems in their business practices for some time, and their experiences provide important insight into systems that promote risk-awareness.

This paper includes sample tools (e.g., criteria, guidelines and dashboard indicators) to help boards and senior management assess risks at various stages in a project's life. These tools are meant to aid in deciding whether a project should move forward, when it should be deferred and when to approach lenders and other stakeholders for assistance.

Throughout this paper, we refer to roles and responsibilities of staff, senior management and board members. These are merely suggestions and not rigid guidelines. We recognize that organizations delineate internal roles and responsibilities based on management structure and available resources. Since an organization's board is responsible for financial oversight and financial planning, it stands to reason that it is the board's responsibility to review and approve project evaluations and dashboards. We understand that for many boards, it is more appropriate for an executive real estate committee or even senior management to make these decisions on a regular basis, involving the full board less frequently and for more high-level issues. However, it is important to ensure that sufficient oversight exists in order to fulfill board duties.

Tracking the Life of a Project:
Five Critical Stages



Developers face risk at each stage of a project's development and throughout operations. For most organizations, it is the development team's job to conduct a thorough and ongoing feasibility analysis to determine whether or a not a project will be successful. It is the asset management team's job to monitor project performance once it is in operation. What, then, is the role of the executive staff and the board?

While the board and executive staff may not examine all of the minute details of a feasibility analysis or a project's financial statements, it is imperative that they are aware of the organizational risks as they make decisions along the way. Not only do best practices recommend this, fiduciary duties require it. Throughout this paper, we will be highlighting board and management roles in setting the direction for development and operations, and overseeing the implementation of those goals.

Among a board's many responsibilities, we will focus on its obligation to:

- Engage in long-range and strategic planning for the organization[1]
- Monitor services for effectiveness and alignment with mission
- Provide financial oversight and protect assets

[1] Richard T. Ingram, *Ten Basic Responsibilities of Nonprofit Boards,* Second Edition (BoardSource 2009).

An early-warning system is a way to monitor the most vital information for decision-making related to specific properties in specific real estate markets.

Each of the five critical stages in a project has its own risk considerations.

Project Stages

1. **Feasibility** – Develop *Go/No-Go* criteria with financial and reputational risk considerations.
2. **Predevelopment** – Use the Feasibility Criteria at various points in a project's preconstruction phase, including acquisition.
3. **Construction** – Create risk categories for projects in construction phase, with each risk category requiring different actions.
4. **Operations** – Build a dashboard that places each project in one of three categories: performing, watch list or workout.
5. **Year 15/End of Compliance** – Consider what the resources and ownership will be for a property for the post-compliance period.

Throughout the five project stages, there are several key indicators that signal a property's tipping point and they are highlighted throughout this paper. The silver-bullet data point or tell-all financial ratio does not exist. An early-warning system is a way to monitor the most vital information for decision-making related to specific properties in specific real estate markets. An organization's staff processes vast amounts of information to provide senior management with data points, and it is senior management's responsibility to distill the information down to the key risk points as the basis for decision-making.

In the next section, we will examine how creating *go/no-go* criteria can help organizations create a framework for evaluating when projects should move forward.

STAGE 1

Feasibility: Go/No-Go Criteria

Feasibility

Predevelopment

Construction

Operations

Year 15 / End of Compliance

Our analysis of 10 distressed organizations in *Building Sustainable Organizations* revealed that numerous housing developers faced financial strain due to optimistic projections on poorly performing properties. Using ***go/no-go*** criteria for determining when a project should move forward may have helped avoid these problems. More often than not, boards and management receive project *proformas* based on the underwriting requirements of funders or investors, not based on the external and internal risks that the developer organization may face. Developers understand how to make sure their projects fit neatly inside of the funder's underwriting criteria. While these criteria enable a funder to evaluate an assortment of affordable housing projects from across the development spectrum, they should by no means be used as the primary analysis upon which an organization's management bases its decisions.

Roles

- **Staff** prepares report demonstrating whether or not a project meets *go/no-go* criteria.
- **Senior managemen**t recommends *go/no-go* criteria; reviews and approves report to the board or project review committee of the board on whether or not a project meets *go/no-go* criteria.
- **Board** approves projects based on *go/no-go* criteria.

Organizations should have very clear roles that define decision-making authority for the board, project managers, asset managers, property managers and managers who oversee staff members. These roles can help ensure that issues are raised to the appropriate level for discussion and resolution.

Organizations must do two things: 1) develop *go/no-go* criteria and 2) create internal project financial underwriting guidelines.

Go/No-Go Criteria

These criteria are strictly for high-level decision-making and should not replace the detailed feasibility analysis performed by development staff. At the earliest stages of predevelopment, the board and senior management should focus on three areas of concern: 1) the property's alignment with the nonprofit's mission and core competency, 2) a project's risks and rewards, and 3) internal underwriting criteria specific to an organization's project type and market.

Mission Alignment and Core Competencies: The amount of financial risk and staff commitment required in development demands careful examination of whether such an undertaking furthers the organization's mission and goals. Pursuing potential development fees can cause organizations to veer away from their mission and core strengths, including their focus on a particular geographic location. In our study, many organizations began to develop properties in cities where they previously had no experience, entering new geographic and political territories without established relationships or market knowledge.

An organization may also move beyond its core competency when expanding a business line. For example, a multifamily senior rental developer may start a single family for-sale project. While this evolution is possible, management must decide how to best handle the risks which will inevitably arise from venturing into new territory. What began as a project that leveraged the organization's core competencies may later include components that are well outside of the organization's strengths, and what began as a project driven by developer fees may become one in need of organizational subsidy as market conditions change.

Risks and Rewards: In addition to the important questions of mission alignment and core competency, *go/no go* criteria must consider the risks and rewards of a project from the perspective of impact on the organization. (See example on the next page.)

- How does the project impact the organization's balance sheet?
- What activities do these risks preclude the organization from taking on in the future?
- Does the project meet the policy goals of public funders so it may be competitive for financing? Are there any political issues that may arise?
- On the flipside, can the project be used to sustain the organization?
- Can it improve the organization's reputation in the community?

Go/no-go criteria can be used to impose self-discipline on an organization. Despite a strong desire to develop a project that may have great value to a community, today may not be the right time to tackle that project. We have seen strong organizations defer or pass up projects that do not meet their guidelines. While difficult, these decisions make financial sense with regard to the organization's sustainability. These organizations cannot continue to serve the community if they fail.

Sample Go/No-Go Criteria

Go/no-go criteria must be tailored to your organization's risk activity, business model and market. The sample below is not based on any one organization's criteria, but was inspired by several risk-aware organizations.

1) Mission/Core Competency

Does the project serve homeless families at 60% AMI or below?	✓
Is the project located within city limits?	✓
Is the project within walking distance of public transit?	
Is the project within walking distance of an elementary school and high school?	✓
Is the project within walking distance of a health care facility that provides services to low-income individuals?	
Is this project aligned with our organization's core competencies?	✓

CHARTS CONTINUED ON NEXT PAGE

2) Risks/Rewards

In the chart below the threshold criteria on the left are examples of criteria that must be met before an organization decides to move forward with a project. The criteria on the right are model criteria that are ideal in a project. Senior management and/or the board will spend the most time considering projects that fall in between.

THRESHOLD	MODEL
RISKS	**RISKS**
• Guarantees must be less than __% of corporate assets	• Guarantees must be less than (__ – 5)% of corporate assets
• Strong likelihood of obtaining funding as measured by a score of at least __ based on the state Housing Finance Agency's scoring system for projects	• Score of __ based on the state HFA's scoring system for projects
• Projected positive cash flow for 15 years after stabilization without recapitalization	• Projected positive cash flow for 25 years after stabilization without recapitalization
• Projected operations generate enough cash to pay for property management and asset management fees	
	• No carrying costs if project not funded
	• No political costs
REWARDS	**REWARDS**
• ≤ 50% of developer fee is deferred	• No developer fee deferred
• ≥ $ __ amount of developer fee*	• $1 million anticipated developer fee
	• Projected operations generate $ __ amount annual surplus cash after accounting for cost of services
	• Strengthens community and/or political support

* To determine the floor amount, an organization should include the cost of getting a project from inception through expiration of operation guarantee obligations, with a cushion for costs incurred for other deals that did not move forward. Regardless of project size, projects often incur some minimum staff and other costs, thereby requiring a fixed fee amount and not simply a variable fee per unit.

Internal Financial Underwriting Guidelines

At the start of a project, development staff perform a detailed feasibility analysis for each project. While the board and senior management will not spend time reviewing each item in an analysis, leadership in an organization can provide general direction for internal underwriting guidelines that reflect the organization's capacity, size, risk appetite, core competencies and other preferences. If this analysis is performed based only on a funder or investor's underwriting criteria, it may not paint an accurate picture of a particular property's future performance. Those criteria typically reflect broad assumptions intended to help differentiate amongst an array of projects to protect an investment. A developer should create underwriting assumptions to reflect both its real estate market and its property type, and those assumptions should account for various scenarios.

Below, we have outlined some pro forma considerations to be used in internal underwriting guidelines. This table is designed to provoke some thought around what is a more likely scenario for a given property and how it will impact an organization's bottom line. We expect each of these items to be customized to an organization's capacity, size, risk appetite, core competencies and other preferences.

Proforma Considerations

PROFORMA ITEM	CONSIDERATIONS
Revenue trending	Most proformas show a 2 percent annual increase in revenue. You may increase/decrease this trend depending on specific project, target resident population and market conditions.
	When the market began to decline in 2006, affordable housing projects across the country faced competition from market-rate projects, and were forced to lower rents. Many projects that do not face such competition also have difficulty raising rents.
Vacancy rate	While proforma vacancy rates are relatively standard, adjust yours based on local conditions, your project type and project size.

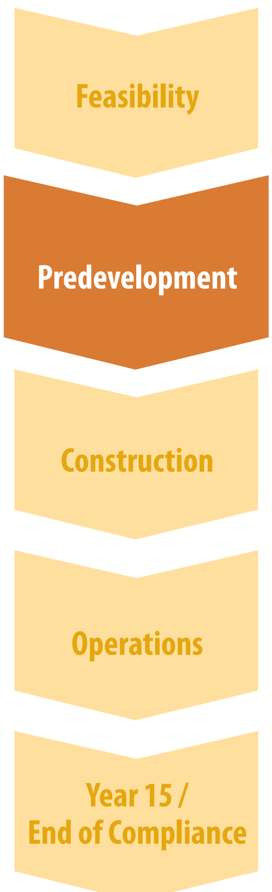
Operating expense trending	Most proformas show a 3-4 percent annual increase in expenses. You may increase/decrease this trend depending on specific project, target population and market conditions, or may consider different trending for various expenses. Few projects meet 3-4 percent expense trending. Consider using actual annual expense increases from your current portfolio to determine more realistic trending for operating expenses.
Resident services fees	Resident services fees may be capped or not allowed as an above-the-line expense in your proforma, but if you intend to provide resident services, the income and expenses associated with them should be included in a feasibility analysis.
Property management fees	Most proformas are underwritten with property management fees as a percentage of rent or specified amount per unit depending on the market.
Asset management	Organizations should include asset management fees that are at least sufficient to cover the organization's cost in performing this service.
Long-term view	When analyzing the operating profoma, look at years 15 and 20 to see that the project is cash-flowing. When funding allows, projects should have cash cushions in year 15 of 5-8 percent of operating expenses, not including reserve balances. Consider dismal assumptions as well.

There will always be risk in real estate development, and the board and senior management must weigh that risk against the organization's mission and financial viability. The *go/no-go* criteria should serve as a framework for checks and balances for the development team and its performance, as well as the board and senior team. When a project is vetted and the answer is "no go," then it falls upon the board and executive management to decide how that revenue gap will be filled in the annual budget. Will the board be required to increase its fundraising or will the executive director need to trim his/her staff? Posing these and other questions lead to a more transparent work environment, and contribute to a more sustainable organization.

The next section will review feasibility guidelines during the preconstruction phase.

STAGE 2

Predevelopment: Feasibility Guidelines in the Preconstruction Phase



After the feasibility stage, the stakes and the risks from a project rise due to increased staff time and increased investment in project costs. At several points during the predevelopment phase, the board and executive staff will be required to provide approval.

Roles

- **Staff** prepares report demonstrating whether or not a project meets *go/no-go* criteria when a triggering event occurs.
- **Senior management** reviews and approves report to the board or project review committee of the board on whether or not a project still meets *go/no-go* criteria.
- **Board** determines which triggering events require review, and approve at those junctures.

Milestones or triggering events requiring review may include:

- Predevelopment/acquisition loan applications and closings
- Site acquisition
- Professional service contracts for due diligence and design activities
- Construction and permanent financing applications
- Permitting applications
- Other requests for funding from outside agencies

When these triggering events occur, the organization should review the *go/no-go* criteria again to determine whether or not the project should move forward. These junctures present the best opportunity to exit a bad situation, which is never an easy decision to make. The distressed organizations that we reviewed often moved forward with infeasible projects in order to recover sunk costs, and put more financial and human capital into these properties. These groups would have been better served moving on to a deal with greater potential.

We advise that organizations create *go/no go* criteria with a sliding scale of restrictions that become less conservative and more accurate as more information becomes available. A board may want to create one set of criteria for a project right at inception and another set of criteria three months from construction closing as some contingencies become obsolete.

In addition to the triggering events above, an organization may decide that there are others which should trigger board or executive staff review of the feasibility guidelines. For example:

- Preacquisition spending over $__ amount or beyond specific items that the board has preapproved
- Entering into a contract over $__ or __% of total development costs or __% of the organization's liquid assets
- Receipt of certain due diligence products, such as environmental reports, appraisals, comprehensive needs assessments and market studies
- __ months have passed since the organization reviewed a project in predevelopment

Mitigating Risk at Acquisition

During the predevelopment phase, the board's focus will expand beyond mission alignment and financial impact. At the point of acquisition, the board should request two new data points: 1) the appraised fair market value of the acquired property as is, including a corroboration of the market study from a practitioner familiar with the market area, and 2) the potential environmental issues of the property.

Several organizations from our research paid high prices for properties during the real estate bubble, and the organizations had no holding or exit strategy. When acquisition costs go beyond budget, staying within the original total development budget means scaling back on construction costs. Limited construction resources result in a subpar property that can reduce rental value during lease-up and operations or require more maintenance over the life of the property. At least one organization has been able to mitigate this risk by structuring purchase agreements so that the purchase price is the lesser of a specified price or the appraised value determined by an independent third-party appraiser hired by a lender, similar to what is required by HOME funds. To make this term more attractive for a seller, the agreement can include a price floor that enables the seller to get out of the deal.

Known or potential environmental issues should be explained in the development team's due diligence, and the remediation costs and financial source of these funds should be presented to the board at this time.

Another way to mitigate the risk associated with the of cost of owning property is to make purchase agreements contingent upon obtaining takeout financing. This may only be possible in some select markets. In all markets, having open communication with lenders who provide lines of credit and predevelopment loans may help to ensure that all available options are considered when unexpected events occur.

While a can-do spirit enables most developers to overcome immense obstacles, the discipline to pull back to prevent grave losses can also save an organization.

Construction Planning

Preconstruction review, like the feasibility analysis, is a project manager's job. The significance of a good scope of work, a good set of plans and contract provisions that facilitate the remediation of problems cannot be overstated. Therefore, some organizations may arrange for review of these items by executive staff or even board members as part of the *go/no-go* decision for a project.

Reviewing risk criteria during the predevelopment stage is another exercise in self-discipline. We know of at least two strong organizations that walked away from projects after investing hundreds of thousands of dollars in them. While a can-do spirit enables most developers to overcome immense obstacles, the discipline to pull back to prevent grave losses can also save an organization.

The next two project stages, Construction and Operations, require a different mindset and understanding of the information than Feasibility and Predevelopment stages entail. Information overload is more of a concern in these two latter stages especially in Operations, and it is vital that senior management get to the heart of the risks through all the data. First and foremost, the developer and/or owner organization must have the right reporting system in place to ensure that it is spotting specific property risks. If an organization's accounting department is unable to track cash costs during construction or produce quality and timely operating statements during operations, then senior management and the board are unable to make informed decisions. Our research showed this to be a recurring concern among struggling groups.

For the next two sections of this report, we offer three categories for projects. If a project makes it to the last category, Workout, then the organization must take action to reduce the property's risk to the organization. (Please note that this definition of Workout does not coincide with an investor's or lender's definition.) The message that must be received by the board and senior management is, "There is a problem and this is what we are doing to fix it." The actions could range from simple fixes to major restructuring. At the next board meeting, the development team should be ready to report on the action taken and its impending results. By following this procedure, the board is able to focus its time and efforts on the problem projects and risks instead of being bogged down in data from the entire portfolio.

STAGE 3

Construction: Criteria for Examining Projects in Construction

After predevelopment, the board's engagement switches from *go/no-go* decisions to monitoring progress of the property's construction. We recommend that the board of each organization be informed of the risk category of each project as part of regular updates on the projects. For example, an organization may use the following risk categories:

- *On Target:* the project requires no special action, and should continue as planned.
- *Monitor Closely:* the project faces minor problems that will need further action if the problems are not remedied.
- *Workout:* the project faces serious problems that require action and decision making by the board and senior management.

Roles

- **Staff** manages construction projects, and provides updates to the board, including the risk status.
- **Senior management** reviews and approves report to the board on risk status, and makes day-to-day risk mitigating decisions.
- **Board** determines acceptable financial (and other) risk level of projects, and how to address projects that have exceeded acceptable risk levels.

During construction, projects typically undergo frequent monitoring. At each board meeting, staff should present updates on each construction project, including an explanation and strategy if a project encounters a change in status.

Here are some proposed criteria for the different categories. An organization should modify as appropriate for its portfolio and market.

Risk Category Criteria

	ON TARGET	MONITOR CLOSELY	WORKOUT
SCOPE	• Unchanged • Minor changes	Medium changes	Significant changes
SCHEDULE	On or ahead of schedule	1 or 2 months behind schedule	3 or more months behind schedule
SOURCES AND USES	Within or under budget	Costs projected to go beyond contingency by $__ ***OR*** Contingency draw-down exceeds the percent of construction completed ***OR*** Projected to cut into contingency by __ percent of TDC, or __ percent of corporate liquid assets	• No contingency remaining • Expecting $__ to finish the project and __ is the expected source for this gap.
TAX-CREDIT ADJUSTERS OR OTHER FUNDING GAPS	None or increase expected	Little change in equity	• Expecting $__ amount to be adjusted down by investor and why there is an adjuster. • __ is the expected source for this gap.
REVIEW	• Executive Management to review on a monthly basis • Board to review on a quarterly basis	• Executive Management to review on a weekly basis or as unexpected events affect schedule • Board to review on a monthly basis	• Executive Management to review on a weekly basis or as unexpected events affect schedule • Board to review on a monthly basis

Potential Actions Beyond Monitoring for the Workout Projects

Once projects are in Workout, the organization must create action items beyond monitoring, but these action items must be tailored to the project's issues. In many instances, the organization must cut costs, seek additional resources and/or minimize additional outlays until workout is accomplished through commitment of additional resources, changing contractors or staff or finding a new partner.

In the next section, we will discuss creating Watch List criteria for lease-up and operations.

STAGE 4

Operations: Watch List Criteria for Lease-up and Operations

Properties in the Operations stage generate less fanfare than those in development due to the large developer fee payments and corresponding development risk. Operating properties require great attention to detail. Success depends on small changes in revenues or expenses which, in the aggregate, may equal profit increases. It is imperative that the board set expectations for property performance to which the entire organization must be held accountable. The board must remain informed so that it can make important decisions before an underperforming property is beyond rescue.

Roles

- **Staff** prepares the portfolio dashboard report to the board on projects in operations with recommendations for action on Watch List and Workout properties.
- **Senior management** reviews and approves dashboard report (see below) to the board, monitors trends in a portfolio and property specific performance, and makes the day-to-day risk mitigating decisions.
- **Board** provides expectations for the portfolio as a whole, monitors portfolio performance and provides leadership for underperforming projects.

Dashboard

When properties are in operation, their performance should be relayed to the board as a dashboard of indicators, and projects should fall into appropriate categories, such as:

- *Performing:* require no special action and limited board review.
- *Watch List:* are at risk, and should be monitored more frequently, with appropriate actions taken as needed.
- *Workout:* face serious problems that require action and decision-making by the board and senior management.

It is imperative that the board set expectations for property performance to which the entire organization must be held accountable.

Organizations with many operating properties have a tendency to bog down their board with reporting. The board's focus needs to be on the risks, the actions to mitigate these risks and the results from these actions. We recommend providing the board with a dashboard of projects that includes only the most relevant information as well as a rating for the property. The board can then review the financials of only the most troubled properties. See sample on page 25.

For your portfolio, different product types may utilize different dashboard criteria. On the next page are some sample criteria, which should be modified for a developer's portfolio and market. Please note that while each criterion may raise a flag, it is often the interaction of multiple issues that is of particular concern. Some projects can have occupancy well under 90 percent and still generate cash flow; others may have negative cash flow but be less problematic as they carry no hard debt. The flag should go up, but there should be additional triggers to raise the level of concern significantly.

Sample Project Performance Dashboard Criteria

	PERFORMING – A	WATCH LIST – B	WORKOUT – C
OCCUPANCY	> 93%	85% to 93%	< 85%
REPLACEMENT AND OPERATING RESERVES	Operating reserves fully funded – at least 6 months of operating expenses and debt service and annual replacement deposits are made.	Operating reserve balance is between 2 and 6 months of operating expenses and debt services and annual payments are made to both replacement and operating reserves.	Operating reserve balance is less than 2 months of operating expenses and debt service and annual payments to both replacement and operating reserves are not made.
MUST PAY DEBT SERVICE	Current	In default ***OR*** Payment is being made by depleting operating reserves ***OR*** Payment is being made through growing payables	In default ***AND*** In arrears for more than 90 days
ACCRUED FEES	Total amount is 2 months or less worth of fees	Increased each quarter for the past 2 quarters ***AND*** Total amount is > 2 months of fees	Increased each quarter for the past 4 quarters ***AND*** Total amount is > 2 months worth of fees
CASH FLOW	Positive ***OR*** Deficits were projected and are covered by reserves that were set aside to cover them ***AND*** Fees to the owner are paid	Cash flow is below projections ***AND*** Deficit is due to a one-time event not expected to recur ***OR*** Fees to the owner are starting to accrue	Negative cash flow for 3 consecutive months or more ***OR*** Deficit is > $5,000/per year ***OR*** Fees to the owner are accrued and have been for many years

CONTINUED

Sample Project Performance Dashboard Criteria, Continued

ORGANIZATION'S SHARE OF CASH FLOW	Each organization is entitled to cash flow from properties that are performing based on its operating agreement. While positive cash flow means the property is performing and belongs in the green category, it does not necessarily mean that the property is providing the organization with any unrestricted cash. It is helpful for decisionmakers to see the actual cash amount that the organization is entitled to even though it has no bearing on the property's red/green/yellow status on the dashboard.		
COMPLIANCE	In compliance with satisfactory inspection scores	Failed federal/state/local physical compliance Received red flags or low inspection scores Failed occupancy compliance	Failed physical compliance not corrected within 60 days Failed occupancy compliance not corrected within 30 days Significant safety issues Any noncompliance on 10% or more of qualified units
PHYSICAL CONDITION	Good condition No deferred maintenance No major repairs required	__ amount of deferred maintenance No major repairs needed	__ amount of deferred maintenance Major repairs over $__ required and __ is the source
TAXES	Current	Past due	Past due for 3 or more months
ACTION	Executive Management to review on a quarterly basis Board to review on an annual basis	Executive Management to review on a monthly basis Board to review on a quarterly basis	Executive Management to review on a weekly basis Board to review on a monthly basis Lenders/Investors to be notified

Fees to the Owner: If property management fees are not paid to the owner, and accrued for more than six months, that property should automatically be on the Watch List and monitored. Accrued fees (that were seldom actually paid) were a recurring issue in our research, and those fees are needed to cover staff costs related to property operations. If they are not paid, then an organization's resources are diverted to pay property or asset management staff rather than being used to move the organization's development or service agenda forward.

Potential Actions Beyond Monitoring for the Workout Projects

Monitoring sometimes reveals issues that require immediate action. That may include notifying the lenders and/or investors to create a stabilization strategy that involves all stakeholders.

As discussed in *Building Sustainable Organizations,* both the developer and the funders need to jointly address solutions if a property appears to be developing issues, especially financial and timing issues. Developers should be transparent with their partners and funders to demonstrate their capacity to address challenges that arise during the construction process. Funders, in turn, also need to foster trust to promote proactive solutions on current and future projects. Funders unable to do this perpetuate project problems and risks. Notifying lenders and investors of challenges and proposed solutions is smart. Lenders maintain industry working relationships that may help a developer get back on track and fix problems before they become too serious.

Also, at this time, if financial gaps appear, then the developer should approach funders with projections showing how much a funder would need to contribute at this time versus later when the gap expands. If the issue is related to a budget overrun on a project, the organization must find ways to either cut costs or find resources to

Developers should be transparent with their partners and funders to demonstrate their capacity to address challenges that arise during the construction process. Funders, in turn, also need to foster trust to promote proactive solutions on current and future projects.

fill gaps. It is important at this point to minimize any additional outlays until the project is no longer in the Workout category if abandonment is the only option. Action steps here can range from changing contractors or staff to finding a new partner for the project.

Potential Action Steps

- Focus on reducing vacancy and collecting rents
- Cut costs – appeal property taxes and make energy-efficieny improvements
- Revisit rent structure
- Evaluate property manager or staff
- Seek additional resources
- Negotiate forbearance agreements
- Restructure debt

The sample dashboard on page 25 is simplified, with red, yellow and green coding for eight projects, including scores from the previous review period for comparison. Scores that have improved are in green, and scores that have declined are in red. For your portfolio, different product types may utilize different dashboard criteria

Sample Portfolio Performance Dashboard*

*This dashboard is based on a fictional portfolio.

Project			Green Briar	Middle City	View Point	Wiggin	Quimby	Bella Vista	Chateau	Whitby
Units			180	185	24	115	106	64	40	100
Occupancy			95% - A	98% - A	80% - C	95% - A	85% - B	64% - C	99% - A	99% - A
Reserves			5 mths - B	6 mths - A	7 mths - A	4 mths - B	8 mths - A	4 mths - B	2 mths - C	1 mth - C
Debt Service			A	A	A	A	A	A	B	A
Accrued Fees			A	A	A	A	B	C	C	C
Cash Flow			A	A	A	A	B	C	A	C
CF to Sponsor			$3,655	$0	$89,017	$1,543	$0	$0	$0	$0
Compliance			A	A	A	A	B	A	A	A
Physical Condition			C	A	B	B	B	A	C	B
Taxes			A	A	A	A	A	A	A	A
Scores	Current	A	6	7	5	6	3	4	4	4
		B	1	1	2	2	5	1	1	1
		C	1	0	1	0	0	3	3	3
	12 months prior	A	3	6	5	6	6	4	3	5
		B	3	2	2	2	2	2	3	1
		C	2	0	1	0	0	2	2	2
	24 months prior	A	1	5	6	7	7	5	4	6
		B	4	2	2	1	0	2	1	2
		C	3	1	0	0	1	1	3	0
Notes			Imp planned for 2012		All vacant units have applicants			Occupancy Increasing	Restructur-ing Debt	

Dashboard: The sample dashboard above provides a summary chart to inform the board of the portfolio's performance. Based on the A, B and C grading above, we recommend that any project that has a C grade should be considered Watch List. More than one C should constitute a Workout property. As with construction projects, projects that move from one category to another since the last board meeting should be explained. Also, the board should receive historical data for watch list and workout properties so they may understand how the property is trending and compare these numbers to portfolio-wide numbers.

Revisiting original proforma operations with actual results is another performance measure. Large discrepancies in these categories may surface as early as year 5 and will signal a property with significant problems ahead if no action is taken. If this data is too specific for the entire board, it should be reviewed by the finance or real estate board committee comprised of knowledgeable board members with a summary given to the entire board.

STAGE 5

Year 15 / End of Compliance: What Is Next?

For Low-Income Housing Tax Credit (LIHTC) properties, Year 15 marks the end of the initial compliance period and the equity investor's exit. It is a key decision point for the owner. In many cases, the property becomes an asset of the developer after the investor exits.

At the beginning of a partnership, the parties negotiate numerous business and legal points. This is best done at the developer's staff or management level. However, the board must determine the organization's policy for handling deals approaching the end of the compliance period, and stay abreast of a few key items of information during the life of the partnership.

Affordable housing properties are typically financed and constructed to require another significant investment after 15 or 20 years. Yet sources used in financing typically have use or occupancy restrictions that extend well beyond this. Owners of these projects must plan for these eventualities, including the possibility of exit.

Year 15 issues are numerous and complex. In this section, we briefly cover significant points in the monitoring of projects for Year 15 issues. We do recommend a more in-depth training for all organizations that have LIHTC projects in their portfolio.

Roles

- **Staff** prepares analysis on properties in the portfolio at regular intervals to determine if any issues will arise at Year 15 should be resolved in the present.
- **Senior management** reviews and approves the staff analysis and presents issues and recommended solutions if issues arise.
- **Board** determines frequency of review and policy for monitoring projects for Year 15 issues.

The development team should begin updating the board in Year 5 of the compliance period about its plans for the property. The board needs to know:

- The status of the limited partner capital accounts. Negative capital accounts can trigger tax consequences.
- The projected value of the property at Year 15, taking into consideration all project restrictions
- The amount of debt, whether it exceeds the value of the property and whether it can be refinanced
- The cost of capital improvements and deferred maintenance
- How much, if any, tax liability may have to be paid to the investor for the investor to exit
- The project reserve balances

Depending on the risk of the property, it may be helpful to perform this analysis on an annual basis starting at Year 5.

Prior to the property becoming wholly owned, the board must evaluate whether the property still aligns with the nonprofit's mission or if it should be sold. A similar process should be followed for other milestones in the project's life-cycle, including the end of use/occupancy restrictions and the end of each material debt term.

Conclusion

While there is no one-size-fits-all solution to creating an early-warning system for projects, creating a solid process leads to greater risk-awareness for leadership. Each organization must undergo a rigorous process to develop a system that fits the organization's business model, market and risk appetite. The process must have sufficient structure to ensure that certain standard factors are considered in decision making, but sufficient flexibility to address anomalous factors. In this document, we have offered tools for shaping an early-warning system. These tools were inspired by some of the strongest organizations that we know. We share them to help other organizations achieve the same level of strength and to build a more sustainable, resilient industry.