Chapter 7
Valuation Analysis & Market Study Requirements

7.1 Purpose of the Valuation Analysis

A. The Valuation Analysis evaluates the existing or proposed project as security for a long-term mortgage. Depending on program requirements, this includes an estimation of the market value of the property and an analysis of the market need, location, earning capacity, operating expenses, and warranted cost of the property.

B. 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 property. The objective of the appraisal 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, reserves and debt service.

7.2 Selection of Appraisers and Market Analysts

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, i.e. HUD-92264, 92273, 92274 etc., is also a requirement. The Lender may assist the appraiser in the preparation of these forms, and the appraiser must sign them unless he/she is not in agreement with value conclusions contained on the forms, in which case the Lender may prepare the HUD 92264-A.

A. Should the Lender have difficulty finding a Certified General Appraiser, the Appraisal Subcommittee of the Federal Financial Institutions Examination Council maintains a national registry of Certified General Appraisers who are authorized, under Federal law, to perform appraisals in connection with federally related transactions. The Lender may review this list at http://www.asc.gov, although inclusion on this list is not an indication of competency to perform multifamily appraisals.

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 appraisal must be ordered and paid for by the Lender and not by the originator, broker, developer or borrower. The appraisal must identify HUD as an authorized user of the report. Appraisals prepared by an affiliate, or not engaged or 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 of all market studies submitted with the application.

E. In the selection of an appraiser or market analyst, there shall be no discrimination on the basis of race, color, national origin, religion, sex, age, or disability.

F. HUD Headquarters' 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 LQMD.

G. The appraiser Certification required by Uniform Standards of Professional Appraisal Practice (USPAP) must include a statement that the racial/ethnic composition of the neighborhood surrounding the property in no way affected the appraisal determination.

7.3 Appraiser and Market Analyst Qualifications

A. Each appraiser must meet the following minimum qualification requirements:

   1. Be a Certified General Appraiser under the appraiser certification requirements of the state in which the subject property is located;
   2. Be currently active and regularly engaged in the appraisal of multifamily properties;
   3. 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;
   4. Have at least three years of income property appraisal experience;
   5. Be knowledgeable concerning current real estate market conditions and financing trends in the geographic market area where the subject property is located, and
   6. Be experienced in appraising multifamily properties with the complexity and characteristics similar to those of the subject property. If the subject contains commercial space, LIHTC or other subsidies, the appraiser must have acceptable prior experience in the appraisal of comparable properties.

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 property inspections of the subject or comparable properties. If any of the persons involved in preparing the report are not certified general appraisers and are acting as an analyst, assistant or trainee, this must be disclosed.

B. 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 Hub/PC may approve appraisers who have temporary certification who have documented how they will achieve competence in the subject's market area in accordance with USPAP.

C. Each Market Analyst must meet the following minimum qualification requirements:

1. Have at least 3 years of experience in performing market analysis for income producing property,
2. Be currently active and regularly engaged in performing market studies for multifamily properties,
3. Be knowledgeable concerning real estate market conditions and financing trends in the geographic market area where the property is located, and
4. Be experienced in performing market studies for multifamily properties with the complexity and characteristics similar to those of the subject property. If the subject contains commercial space, LIHTC or other subsidies, the market analyst must have acceptable prior experience in the market of comparable properties.

D. If the Hub/PC believes that a Lender is contracting unqualified or unlicensed appraisers or market analysts, the PC must refer the case to LQMD for investigation.

7.4 Market Study Applicability and Requirements

A. Applicability. For all new construction properties and all substantial rehabilitation projects with significant resident displacement, resulting in negative cash flow during the rehabilitation period and for all LIHTC transactions without project based rental assistance, the appraisal and market study should be completed by different firms. The Hub Director can waive this requirement on a case-by-case basis, if it is clear the appraiser or appraisal firm is capable of performing both the subject appraisal and the macro market analysis, and if the strength of the market is not in question. Section 223(f) proposals typically do not require a market study separate from that contained in the appraisal, however, in volatile or declining markets, the Lender should consider, and may be required to obtain, such a market study to support the underwriting conclusions of market demand for the subject property over the loan term. Market studies are not required for properties with at least 90% of the units covered by a long term (5 years or more) rental assistance contract and with any rent increase confirmed before initial or final endorsement.

B. Requirements. Each market study must meet the following requirements:

1. Meet the requirements of Section 7.2.B and D.
2. Meet the content and format requirements of Section 7.5.
3. Effective Date. For pre-applications, the effective date of the study must be within 120 days before the date of the pre-application package. For Firm Commitments, the effective date of the study must be within 180 days prior to the issuance, re-issuance or amendment of the Firm Commitment. Expired reports must be updated as needed by re-surveying all relevant data.
4. Have the information from the Lender listed in Appendix 4.
5. Be prepared in conformance with the market study format in Section 7.5.
6. In cases where a waiver is granted and the appraiser prepares the market study, it must be submitted as an independent exhibit and separately bound report.
7. Include the market analyst's certification per the format in Chapter 11.

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 or incremental demand. The market study is typically narrow in its geographic coverage than the market analysis prepared by EMAD, which analyses the broader MSA. The study must estimate the number of renter households with sufficient incomes to afford the type of housing at the rents proposed. In addition, the study must estimate the number of units that the market could reasonably absorb over a specified forecast period, which is typically three 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, age 62 and over, the study must estimate the number of elderly households with sufficient incomes to afford the type of housing and services under study, 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. Useful information may be obtained from the Form HUD-92013, "Supplemental Application and

Processing Form Housing for the Elderly/Disabled."

B. 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. a statement of key conclusions reached by the analyst;
4. a statement of the analyst's opinion of market feasibility, as determined by factors of market demand;
5. recommendations and/or suggested modifications to the proposed project, if appropriate;
6. a summary of competitive advantages and disadvantages, and issues that will affect the property's marketability, performance and lease-up, as well as points that will mitigate or reduce any negative attributes.

C. 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 market rents and gross rents by unit type. (Gross rent is defined as the cost of renting the unit, including the cost of resident paid utilities.)
3. The unit and project amenities and services.
4. 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.

5. Description of 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).

   The report must address, in sections E. and G., how these incomes and rent restrictions will affect potential demand, absorption and long term stabilized occupancy of the income-restricted units.

6. Characteristics of the proposal that will have a specific bearing on its market prospects and overall marketability, such as location, amenities, features or design.

   a. For projects designed for the elderly, age 62 and over: The estimated total monthly fees for shelter and any separate fees charged for any optional services per resident by type of occupancy or accommodation.
   b. The estimated total monthly fees for any optional services provided on an as needed per resident basis.
   c. The proportions of the project to be occupied by market rate residents and by public pay/assisted residents-tenants, e.g. Optional State Supplement.
   d. The amenities and special services to be provided and how they support the physical, mental, or social conditions of the prospective residents.
   e. The project location and its proximity to facilities and services essential to elderly residents such as hospitals, medical/health care facilities, social and community services, public transportation, shopping and recreational activities; and any other locational considerations relevant to the market or marketability of the proposed project. Include a map showing the site and important facilities and services.

D. Housing Market Area (HMA) 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 come from must be discussed. The size of the HMA for general occupancy rental housing can vary significantly depending on the extent and location of comparable and competitive products within a specific area. 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 2000 to 2010 (once available) Decennial Census, American Community Survey (ACS) and local sources will aid in this determination. The market study must include the following:

1. A map of the HMA, 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 HMA and a justification for the delineation, including a discussion of the location of competitive housing, relevant services and amenities and concentrations of employment opportunities.

3. A description of the sub-market for the type of housing proposed, defining the economic and demographic characteristics of the target market in terms of income levels, household size and age range of prospective residents.

4. A statement of the length of the specified forecast period, which is typically 36-48 months from the current date of the study.

5. For projects designed for the elderly, age 62 and over:

   a. the locations of the prior residences of the current occupants in comparable and competitive existing projects,

   b. location and access to relevant services and amenities,

   c. any concentrations of elderly population,

   d. a description of the sub-market for the type of housing and care proposed by the economic and demographic characteristics of the target market (projected residents): income levels, wealth and assets, household size, age of prospective residents, physical and/or mental limitations, homeownership rates, and other similar factors,

   e. description of the current inventory foreclosures and defaults, quantitative and qualitative characteristics of projects in the market area, occupancy rates and waiting lists,

   f. total monthly charges by unit type, including the monetary level of concessions, type of accommodation, and level of services,

   g. typical types of services and amenities offered, whether mandatory or optional fee for services, and whether services are provided by the facility (directly or by contract) or through a third-party arrangement (tenant-resident and provider and any added costs for optional services), and

h. absorption experience of recently completed projects on a units per month basis, discussing the level and extent of pre-sale or pre-marketing efforts.

6. For LIHTC Projects. Provide an estimate of demand, including a capture rate, based on potential income eligible residents. An income eligible resident is a resident whose income does not exceed the maximum permitted by the affordability restrictions but who has sufficient minimum income to pay the LIHTC rent without being overburdened. To make these determinations, consider the following information and guidance:

   a. 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 overburdened, which can result in a problem with the market feasibility of the project. Depending on the rental market and income conditions in the HMA, there may be an insufficient number of potential renters that meet the income limit and who are also able to pay the restricted rent. In many markets, LIHTC projects set their rents below the maximum permitted. Some LIHTC projects have other forms of assistance (such as Section 8 rental assistance or soft subordinate financing) to further reduce rents and thus expand the number of income eligible residents.

   b. The determination of demand and the capture rate should take into consideration:

      (1) the current and anticipated supply/demand conditions in the overall rental market,

      (2) the potential depth of the market of income eligible households in comparison to the number of units at the proposed rents, and

      (3) 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.

   c. Capture Rate is defined as the percentage of households in the HMA that meet any applicable age and household size restrictions and are within any limited income eligible band and who have sufficient minimum income to pay the tax credit rent without being rent overburdened, who the property must capture to fill the units and achieve stabilized occupancy. The Capture Rate is calculated by dividing the total number of units at the property by the total number of households that meet the applicable age, size and any income band requirements. The absorption rate is defined as a projection of the pace of unit lease up as units become available for occupancy.

The Hub/PC should consult with EMAD in assessing the determination of eligible income band, capture rate and absorption rate contained in the market study. If the Hub/PC finds that there is insufficient demand for the units at the proposed rents, the loan should be either rejected or revised by the Lender with rents lowered as necessary to broaden the band sufficiently to ensure adequate absorption and achieve stabilized occupancy. If agreement cannot be reached with the borrower on the appropriate rent levels, the project should be deemed to be not feasible and rejected.

E. General characteristics of the HMA. The market study must include a thorough description of the current and forecast economic and demographic characteristics and conditions of the HMA. The description is necessary to provide background and justification for the subsequent estimates of demand for additional rental housing. The study must include the following:

1. A discussion of current economic conditions and employment characteristics, including:

   a. 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.

   b. A study of recent trends in employment, including unemployment statistics and new job creation or loss, with a detailed discussion of:

      (1) 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.

      (2) Information on the types of new jobs being created and lost, including data on pay scales and how these wage levels relate to the affordability of the proposed rental units.

      (3) List of major employers in the HMA, the type of businesses and the number employed.

      (4) In relevant markets (such as resort areas), comment on the availability of affordable housing for employees of businesses and industries that draw from the HMA.

c. A forecast of employment for the specified forecast period and how this forecast supports demand for additional new rental housing.

2. A thorough discussion of past and anticipated future trends in the demographic character of the housing market, covering such subjects as population change, migration, net natural change, household growth or decline, changes in the average household size and changes in tenure. The report must include estimates of the total population and households (by tenure - owners and renters) that include the current date of the study and the forecast date (three or four years from the date of the study) and a detailed explanation of all significant trends and changes.

3. Income Restricted Projects. Provide a discussion of other income–restricted projects that are existing are under development or are proposed in the HMA, while keeping in mind the eligible income band. Particular attention must be given to existing, under construction and proposed projects that would require an eligible income band that is similar to the subject's.

F. Current housing market conditions. The market study must include a comprehensive description of the current conditions of the rental market and of the sales market, if relevant, in the HMA. 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, including the following:

1. An estimate of the current competitive rental inventory, of both single-family and multifamily units, in the HMA, with data on the number of units by structure type, by number of bedrooms, by rent levels, age and location.

2. A thorough discussion of recent market experience analyzing the following:

a. Current occupancy levels and recent trends in occupancy/vacancy in existing rental projects.

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. When available, annual absorption of new projects from the past 10 years should be provided.

c. Current gross rents for comparable and competitive projects, and the trend in rent increases 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, including the cause if the subject's rates are significantly higher or lower than the overall rental vacancy rate.

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 single family and condominium rental market.

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.

G. 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 the numbers 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 their locations.

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 projects designed for the elderly, age 62 and over:

a. Total monthly charges by unit type, type of accommodation, and level of services, with information on the added costs for optional services.

b. Typical types of services and amenities offered, whether these are mandatory or optional fee for services, and whether services are provided by the facility (directly or by contract) or through a third-party arrangement (resident and care provider).

H. Demand Estimate and Study. The market study must include an estimate of future demand for the specified forecast period, typically 36 to 48 months. The estimate of demand and the study supporting that estimate must meet the following guidelines:

1. The estimate of demand must be based on a calculation of incremental demand 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.

   c. Replacement of existing rentals lost from the inventory due to demolition, conversion, shifting owner units into the rental market and by other means, and consideration of any current excess vacant supply based on a balanced market vacancy rate. The demand estimate must reflect the number of rental units that, if added to the inventory, would promote balanced market conditions.

2. The estimate of demand should be broken down into a qualitative estimate of demand by number of units by bedroom size, rent range, and other relevant characteristics, as necessary.

3. The demand estimate should identify the "effective demand" 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.

4. The study must reconcile the number of units in the proposed project with the demand estimate for the HMA, taking into consideration current housing market conditions, available vacancy, and forecast additions to the supply (under construction and in the pipeline). The study should also include an estimate of the absorption period needed for the project to reach sustaining occupancy based on current market data and the *quantitative and qualitative demand* estimates.

5. The market study must include an assessment of the impact the proposed project would have on existing rental developments. Specifically, the study must address the impact on existing insured properties and show that demand will come 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.

6. For projects designed for the elderly, age 62 and over:

   a. The demand estimate should reflect "effective demand" and should be based on the numbers of elderly households meeting the relevant economic and demographic criteria (sufficient incomes, age, household size, and need for the type of shelter and care) that reasonably could be expected to demand such housing during the forecast period.

   b. The report must include a descriptive study of the demand estimate that addresses the primary determinants including:

      (1) Current and forecast population and households of the target group(s) by age cohort and the proportion of the market each group comprises.

      (2) Current income level/band of income of prospective households comprising demand, including cost/rent to income ratio(s) assumed in the study.

      (3) Changes in the population (including migration patterns) of adult children of the potential elderly occupants. Discuss the impact of anticipated population changes on the demand for the project and the portion of demand expected to come from outside of the primary market area.

7. For Income Restricted Projects. Discuss demand and calculate the capture rate based on the eligible income band considering the proposed project's income restricted unit mix and restricted rents. In calculating the capture rate it is important to confirm that the income qualified renter households in the HMA used in the determination have an eligible income band similar to the subject.

I. Additional Requirements for Projects designed for the elderly, age 62 and over Basic Assumptions of the Study. The technical and analytical methods used by the market analyst and all conclusions must be consistent with the following assumptions:

1. There is a direct relationship between the housing and needs or requirements of an elderly person and the limitations in activities of daily living imposed by the physiological, psychological, and social changes of the elderly. Therefore demand and need vary between different age-cohorts of elderly for particular types of housing.

2. The demand within each age-cohort for a particular type of product will depend on the housing and services offered and how well these meet the physical, mental and social conditions and service or care needs of persons within each age-cohort.

3. In addition to their normal source of income (pensions, social security, and retirement funds) the elderly demanding shelter and care will use some portion of their assets (net worth) to defray the cost of shelter and care. Elderly homeowners may sell their homes and use part of the investment income from the net equity toward the monthly housing expenses.

4. The proportion of income an elderly household is willing to pay for a particular housing product (cost-to-income ratio) will depend on the type and extent of services included in the total monthly cost. The more extensive the level of shelter and services the higher the ratio. The cost to income ratio is defined as the sum of the shelter rent, utilities, and typical service charges, divided by the total monthly household income. Cost to income ratios are a function of the type of housing product and the level of services and amenities provided. The cost to income ratio used in the study should also reflect what is reasonable and customary for the particular type of housing in the subject market area, taking into consideration recent market experience of comparable and competitive product. A guideline for cost-to-income ratios for age-restricted rental apartments with no services should be 30 percent or less.

5. One-person households comprise the major segment of the demand for housing and supportive services for the elderly. Therefore, any estimates of demand based on data for the total elderly population or for all elderly households, must be adjusted to be consistent with actual market experience and occupancy by household size in existing competitive product.

6. Household Sizes and Counts. Use of data on all household sizes must be adjusted to derive an accurate demand estimate, consistent with the characteristics of the target market. If an analyst makes an estimate of demand using data for all households, without making an adjustment for household size, the subsequent estimate of potential demand will be significantly overstated.

7. Using counts for total households substantially overstates the number of income affordable households. Census data indicates that incomes of two-person households are approximately twice that of respective one-person households. Consequently any distribution of elderly households will have a greater proportion of two-person households in the upper income ranges than one-person households. Analyses shows that at most every income level, two-

person households typically out-number one-person households by a factor of two or three to one, depending on age.

8. Unless a factor is applied to the "all household" count to adjust for this bias the demand estimate is incorrect. The method most analytically consistent with the observed facts of the target market for most seniors housing would be to measure the numbers of elderly one-person households, with incomes sufficient to afford the type of housing, and then adjust this count to take into account households of other sizes.

J. 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.
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> The competency required of appraisers and market analysts to appraise or prepare market studies on 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 the programs in the local subsidized housing submarket, as well as in the general market that is unaffected by subsidized housing programs, and must be aware of possible political changes that will affect the continued availability of the subsidies and must fully understand the requirements for subsidy programs. A lack of knowledge and understanding of the impact of the unique influences that affect subsidized housing projects could lead to misleading conclusions.

K. Data, Estimates, and Forecast. The study should document the methods and techniques used to develop all estimates and forecasts and provide adequate citations on the sources of all data, estimates and forecasts which citations must be relevant and current. 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.

L. Useful Information. Distributions of total renter households by size of household (1, 2, 3, 4 or more persons), or by age of householder (15 to 61, 62 to 74, or 75 and older) by income intervals are readily available from the HUDUSER website, http://www.huduser.org/ datasets/spectabs.html.

7.6 Appraisal Requirements

A. Each appraisal shall be presented as a Self-Contained Report prepared in accordance with USPAP Standards Rule 2. The development of the appraisal must comply with USPAP Standards Rule 1, and the Scope of Work Rule and assignment conditions outlined throughout this guidebook. The report should contain all of the information necessary for loan underwriting and for the HUD review appraiser to easily understand the reasoning employed by the appraiser.

B. Complex or Unusual Appraisal Assignments. Experience has shown that changes in the cost and manner of constructing and marketing commercial, industrial, and residential real estate as well as changes in the legal framework in which real property rights and interests are created, conveyed, and mortgaged result in corresponding changes in appraisal theory and practice. The appraisal profession is constantly reviewing and revising appraisal methodology to meet these changes. When an appraisal assignment involves a subject with property rights issues or other unusual circumstances, third party appraisers must be sure to compliance 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 an appraisal or consulting assignment involves complex or unusual valuation issues, the appraiser and the Lender should consult with the Hub/PC before beginning the assignment.

C. Form HUD-92264 and supporting forms HUD-92273, HUD-92274, and HUD-92264T (if applicable) must also be prepared and included in the report along with a copy of the Lender's HUD-92264-A, or a draft completed by the appraiser. The appraisal report must be supportive of and consistent with the conclusions made on the forms.

D. The USPAP Jurisdictional Exception rule is not generally applicable in HUD appraisal assignments. Limitations on occupancy rates and commercial income/space, etc., imposed by the insurance programs are considered to be conditions of the assignment.

E. Occupancy Percentage. The estimate of occupancy for residential properties should be based on the occupancy that is prevalent for the subject's area, without regard to FHA programmatic constraints imposed on the maximum underwritten occupancy when calculating debt service coverage. 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. The estimate should ignore unsustainable market conditions, short-term spikes in the occupancy rate due to reasons such as seasonal changes and short-term demand for specialized employment, i.e. disaster relief workers.

F. Sections 220, 221(d), and 231 (new construction only) do not call for an "as complete" value conclusion. The valuation for these programs is considered an Appraisal Consulting Assignment subject to the development and reporting requirements outlined in Standards 4 and 5. However, the appraiser must ensure that any opinion of value that is used in the consulting assignment was developed in accordance with Standard 1.

1. These are replacement cost limited mortgages by mandate of the National Housing Act and require a site valuation, a debt service analysis and a cost approach to value. An estimate of the market value after completion is not required. The appraiser must fully examine the proposed construction costs of the subject property. Plans, specifications and development costs must be presented, analyzed and supported by the cost approach using either a subscription cost service such as Marshall & Swift, the Lender's 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 property 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 only.

2. According to the USPAP, "Standard 5 does not dictate the form, format, or style of real property appraisal consulting reports. The form, format, and style of the report are functions of the needs of users and appraisers. The substantive content of a report determines its compliance." Therefore, the appraiser and the MAP underwriter must assure that there is sufficient narration 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.

G. For Section 223(f), all three approaches to value must be utilized for subjects that have an actual age of less than ten years. When there are repairs or allowable improvements proposed, these appraisals must be prepared assuming those repairs/improvements have been completed and rents and expenses must reflect completion of the proposed repairs or improvements.

1. Cost/ Summation Approach. The cost or summation approach must consider all applicable forms of depreciation, functional and external obsolescence. For this reason, the cost/summation approach shall not automatically set the upper limit of value for these programs. However, this policy is not intended to negate the necessity of the final reconciliation of the three approaches but is rather an acknowledgment of the basic principle of substitution in that no prudent purchaser would pay more for a property 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 typically does not offer a convenient basis for comparison with other entire projects due to differences in size, composition, areas, units and rooms. Acceptable units of comparison are price per living unit, price per room, and price per square foot of gross building area (GBA).

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 property. The preferred method of capitalizing the NOI into a value estimate is Direct Capitalization. There are several acceptable techniques for deriving capitalization rates. Rate Extraction based on recent (preferably within the past year) comparable sales is the most preferred. Band of Investment, Ellwood, and Sinking Fund, etc. are also acceptable. The appraisal should also contain discussion of how the chosen capitalization rate compares to rates listed in published reports such as Korpacz, realtyrates.com, etc. The Department does not recognize the use of Discounted Cash Flow Analysis on appraisals for mortgage insurance.

   The Capitalization Rate must be based on factors reflecting the overall demands of knowledgeable investors in properties similar to the Subject. Regardless of the method used in deriving the rate; it must be supported by current market information, i.e. recent sales, typical loan terms and return on owner's equity. The appraiser must report all market comparables used to derive the Capitalization Rate.

H. For Section 231 Substantial Rehabilitation cases, follow the instructions for Section 223(f). Substantial rehabilitation under Section 231 differs from Sections 220, 221(d)(3) and 221(d)(4) in that a market value based on the completion of the rehabilitation is required.

I. Remaining Economic Life (REL). REL is defined as the estimated period during which improvements will continue to contribute to property 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.

   1. For new construction and substantial rehabilitation projects, the maximum mortgage term is the lesser of 40 years, or 75 percent of the REL.

   2. For existing properties, the maximum mortgage term is the lesser of 35 years, or 75 percent of the REL.

   3. Estimation of the REL is first accomplished by determining the economic life of the improvements (as new) through market analysis and/or an appropriate reference source. The appraiser then reduces the economic life (as new) by the effective age to determine the estimated REL. For example: original economic life (say 55 years) is

reduced by the effective age (say 15 years) = 40 years estimated REL. The effective age is determined by the appraiser based on the actual condition of the subject considering all applicable forms of depreciation, and after assuming the required repairs to be made as specified in the PCNA as a condition of refinancing. The REL is then multiplied by 75 percent to determine the maximum mortgage term as described above. In this example, the maximum allowable term for the mortgage would be 30 years (55 less 15 = 40 x .75 = 30 or the lesser of 35 years or 75% of REL (30). The methodology and reference/data sources used by the appraiser must be clearly set-forth in the report and must consider all of the following factors:

a. The economic make-up of the community or region and the ongoing demand for accommodations of the type represented.

b. The relationship between the property and the immediate environment. Older properties may have legally non-conforming use if they pre-dated real property zoning for the neighborhood. Observations within the neighborhood in which the subject is situated may reveal a conflicting relationship. This should be fully explored to determine any potential external obsolescence.

c. To the extent possible, the appraiser should analyze architectural design, style and utility from a functional point of view and the likelihood of obsolescence attributable to new inventions, new materials, changes in building codes, and changes in tastes. The appraiser should indicate in the Scope of Work the steps taken to accomplish this requirement.

d. The trend and rate of change in the characteristics of the neighborhood that affect property values and their effect on those values.

e. Workmanship and durability of construction and the rapidity with which natural and man-made forces may cause physical deterioration.

f. Physical condition and the practice of owners and occupants with respect to maintenance, the use or abuse to which the improvements are subjected, the physical deterioration and functional obsolescence within the subject property.

The REL directly impacts the amortization period and the maximum insurable mortgage. An over-estimate of the REL can lead to greater risk to the Department. An under-estimate can unfairly penalize a project. HUD review appraisers should carefully scrutinize the methodology used in estimating the REL.

J. 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.) Any irregularities noted during the appraisal review process may trigger a review of the appraiser's work file.

K. 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 Hub/PC 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, comparables and has made estimates of rents and expenses. Updated appraisals can be submitted if the appraiser re-inspects the subject property, re-surveys the rental comparables, and reviews the market for any additional sales comparables. Follow USPAP Advisory Opinion 3 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 Commitments.

L. The appraisal must be prepared with the list of information contained in Appendix 4.

M. Include an appraiser's Certification with the format in Chapter 11.

N. 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.

    1. 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 is 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 whereby individual units within 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.

2. For large projects exceeding 500 units, the Lender may request a lesser percentage and 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.

3. The primary appraiser must inspect all of the comparables used in deriving and 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 property whose contact information must be documented in the appraisal report.

O. 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.

P. 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 so as to determine the ability of an existing property 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:

1. Location. This includes a general description, specific analyses of site linkages and urban growth determinants and detailed competitive location rating.

2. 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.

3. 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 Hub or Program Center.

7.7 Estimating Project Income

A. Rental estimates. 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, the effect that any proposed repairs to the project will have on rents, expenses, and net income must be considered, although not all repairs increase rents, occupancy, net income, and/or decrease expenses.

B. Rent comparables. Market rent by comparison shall be estimated by the appraiser and documented on the HUD-92273. Note that use of Form HUD-92273-S8 is not authorized for application processing.

1. A separate HUD-92273 is to be prepared for each type and size (if significantly different) of rental unit in the subject property.

2. The rent comparables and units selected for comparison must be as similar as possible to the subject property 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 property, appraisers should generally not use rent comparables located outside of the subject's market area unless there is a lack of recent comparables in the subject's immediate market area. In this case, the comparables selected should be from areas similar to the subject and this should be fully explained in the report.

3. Market rate units from partially assisted projects can be used as rental comparables in the absence of better rental data.

4. 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. Rental adjustments are always made to the comparables for differences with the subject project.

5. The appraiser should select the final rent estimate based on accepted correlation procedures:

a. Generally, the indicated rent estimate will be from the central 60% of the rental range of the indicated rents after proper adjustment. 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.

b. 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.

C. On LIHTC and/or bond financed projects, the Form HUD-92264T must be completed to determining the appropriate processing rents.

D. Rents as of the appraisal date or market study date. 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.

E. Equipment included in the subject rent must be identified–such as ranges, refrigerators, microwave ovens, air conditioning equipment and laundry facilities. Services included in the subject rent frequently include heat, air conditioning, water, and trash removal. 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.

F. Occupancy/Vacancy and Collection Losses For Residential Units.

1. 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 property, the rental comparables and any anticipated changes in the market. The factor selected must reflect long-term occupancy rates that are expected to continue.

2. 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 should take into account the vacancy and collection loss typical for the subject's market area and, if applicable, be consistent with the subject's historical performance.

G. 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. 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 Chapter 3 for a more complete synopsis of space and income limitations.

Unlike the valuation of the residential portion of a mixed use project, when establishing the value of the commercial portion of the project, the appraiser must apply the same programmatic limitations on commercial occupancy; space and income as are imposed by the programs when establishing 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 for each comparable a photograph, the resident's name, type and address of business, square feet, rent, vacancy, any concessions and major lease terms. 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/substantial rehabilitation to obtain effective gross commercial income for underwriting purposes. Provide for each lease, 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.
2. Limitations on the amount of commercial space and income vary by program (see Chapter 3) and must be applied in the valuation analysis.
3. 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.
4. Unlike the valuation of the residential portion of a mixed use project, when establishing the contribution to value of the commercial portion of the project, the appraiser must apply the same programmatic limitations on commercial occupancy; space and income as are imposed by the programs when establishing the commercial NOI for calculating debt service coverage (see Chapter 3).

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 had 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. 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) what is 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.M.2.

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 the portion of the comparable's 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. Consider the subject location relative to distance from shopping, recreational, social, and medical and employment centers, neighborhood desirability, transportation, special hazards and nuisances.

L. Project Amenities and Other Factors.

1. Among those "other" items that may be considered, but are not limited to, are 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 here features of location of unit within the project, such as view,

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

M. Other Income

1. Ancillary Income. The appraiser may consider other income from resident related sources including, but not limited to, laundry facilities, parking, and other recurring and reliable sources such as equipment rental, vending machines, and cable fees in the calculation of other income based on the operating history of the project, if applicable, and whether income from these sources are common in the market. The appraiser can consider the net amount of this other income based on the actual or projected (as appropriate) amount received, adjusted for vacancy and income loss. The analysis must be discussed in the Remarks Section of Form HUD-92264.

2. Commercial Income. 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 as ancillary income and is treated separately (as noted above) from commercial income. However, income related to parking or other community facilities from non-residents must be treated as commercial income and is subject to the restrictions on the underwritten occupancy rate as noted in Chapter 3. The space occupied by parking and community facilities is not included in the calculation for allowable commercial space. Commercial parking spaces reserved for use by motorists who are not property residents or are not parking to use the on-site commercial tenant’s facilities, and the related non-tenant parking income, 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 are to be acquired, refinanced or will undergo substantial rehabilitation, that provide parking for a monthly fee, 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 market study, appraisal and underwriter's narrative.

If the borrower operates a parking facility that provides parking for residential or commercial tenants of the property, 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.

3. Short-Term Lease Premiums. Projects with lease terms that are less than 30 days are not eligible for HUD-insured financing under any circumstances. Income from other short-term leases may be considered to the extent that it is present 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.
4. Corporate Leases. Corporations and businesses are eligible residential residents in insured projects, so long as the lease term exceeds 30 days although compliance with the policy on Short-Term Lease Premiums is required. For underwriting and valuation purposes, the percentage of total gross income obtained from corporate leases shall not exceed 10%.
5. Ineligible Income. Ineligible income should be noted and discussed in both the self-contained 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 include, but are not limited to pet fees, pool fees, forfeited security deposits or forfeited rent.
   c. Furnished Units. Furnished units must be underwritten at the same rental rate as for unfurnished units. This applies to all units, including for corporate and short-term leases.
6. Non-Shelter Services/Elderly Developments. Refer to Section 3.4.S.

7.8 Operating Expense Estimates

A. Purpose. A determination is to be made of the portion of gross income which must be used to maintain, operate and repair the property and to defray the costs of ownership. An accurate analysis of operating expenses is essential to determining a realistic net income estimate for the project.

Form HUD-92274, Operating Expense Analysis Worksheet, is to be used for the development of project expense estimates for Section E of Form HUD-92264, Project Income Analysis and Appraisal. Form HUD-92274 will be prepared for all cases and must be included in the processing file as supporting documentation for Form HUD-92264.

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, 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 property 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 not more than $10,000 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, the borrower must submit a statement through the Lender that explains why all the required records are not obtainable. The Lender must also certify that they have evaluated the borrower's statement and agree that the information is not available. After reviewing the two aforementioned requirements, the Hub 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. Furthermore, 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 property and to continue the production of effective gross income. 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 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 property 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 property 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 and formulas used for determining the required replacement reserves when calculating debt service coverage.

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 of 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 reflected in a suitable unit of comparison–such as expense per unit per annum (PUPA), expense per room per annum (PRPA), 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 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 property. 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. 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 property description, unit mix, and the physical characteristics of the comparable's 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 HUD review appraiser 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 HUD review appraiser 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 process of correlation must be used to 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 1st to December 31st is January 1st 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 comparable's 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 property's expenses are then correlated from the array.
    c. Once the correlated line item expenses for the subject property 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 HUD appraiser 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.

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 property 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. (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, 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 residents, the location of a project designed for such occupancy shall be within a reasonable walking 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. Consideration must be given to the effect on parking facilities in the neighborhood and on all-night parking, in particular, which would be caused by the additional number of cars of the residents who would live in the proposed project. If the project site lacks adequate space for parking residents' cars, the availability of other off-street parking space must be considered. An estimate must be made of the number of parking spaces which would be required by the residents of the proposed project and their guests and a recommendation must be given as to the adequacy of the parking facilities to meet the estimated need of residents.

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. Sites/Projects Sold by a Public Body.

1. The Market Value of Land Fully Improved or the "As Is" Value of a Proposed Substantial Rehabilitation Project. 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 found by comparison with other sites having 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). This is not a complete list of items covered, but will serve as a guide to the acceptability of costs required by the purchase contract.

When the subject is a site or project sold by a public body, the appraiser must still provide an estimate of the true market value of land or the "as is" market value of an existing project, as if it were sold by a private owner. This should be noted in the remarks section of the Form HUD-92264.

2. "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 1.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.

I. Site Value for Subsidized and/or LIHTC Projects: The site value is to be estimated using a capitalization rate and property NOI as if the units and the property were unrestricted and market rate, without considering: a) any additional value that may be attributable to subsidies available to the project or to any LIHTCs or other tax benefits the property 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 property at its market value for new construction or rehabilitation of affordable housing. The value attributable to the presence of LIHTC's diminishes over time and is not always freely transferable, and thus should not be taken into consideration.

J. 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. Exhibits:

1. Application for Multifamily Housing Project, Form HUD-92013
2. Location map
3. Phase I ESA with a narrative environmental report. If the Phase I Assessment indicates a need for further study, a Phase II Assessment should also be submitted.
4. Evidence of site control (deed, purchase agreement, or option)

5. Market Study
6. Estimate of Market Rent by Comparison, HUD-92273
7. Photographs and location map of rental comparables used in the HUD-92273 analysis.
8. Operating Expense Analysis Worksheet, HUD-92274
9. Estimate of the warranted price of the land for new construction or the "as is" value of the land and building for substantial rehabilitation cases.

B. 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.
   f. Estimate mortgage amount based on HUD-92264-A, Criteria 5, 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.
2. The Phase I ESA report 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 property.
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.
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 HUD-92264, HUD92264-A, and supporting forms.
7. The Lender must compare the calculations on the 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.

C. HUD Review:

1. The Lender must submit the exhibits listed in Section 7.10.A to HUD.
2. The HUD appraiser and the EMAD economist must each provide a desk review of the market study. The HUD appraiser must make final recommendations to the team leader regarding market demand for the project.
3. The HUD appraiser must inspect the subject site and all of the comparables used in the appraiser's HUD-92273 and HUD-92274 analyses.
4. The HUD appraiser (or other designated Environmental officers) must review the Phase I ESA, and complete the HUD-4128, "Environmental Assessment and Compliance Findings for Related Laws" and the sample field notes checklist.
5. The HUD appraiser must review site characteristics and make a recommendation regarding site acceptability to the team leader.
6. The HUD appraiser must determine that the comparables submitted are acceptable.
7. From a review of Forms HUD-92264, HUD-92273 and HUD-92274, and supporting information, the HUD appraiser must make a recommendation (format in Appendix 7) 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. Any recommended modifications necessary to approve the application instead of a categorical rejection. Any value conclusions made by the HUD review appraiser that differ from the appraisal under review require preparation of a work file in accordance with Standard 1 of USPAP.

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

A. Exhibits:

1. Application for Multifamily Housing Project, Form HUD-92013
2. Evidence of permitted zoning
3. Evidence of last arms-length transaction and price
4. Appraisal
5. Rental Housing Project Income Analysis and Appraisal Form, HUD-92264
6. Supplement to Project Analysis, HUD-92264-A
7. Updated estimates of Market Rent by Comparison, HUD-92273
8. Updated operating Expense Analysis Worksheet, HUD-92274
9. All exhibits for HUD to complete the Environmental Assessment and Complete Findings for the Related Laws (HUD-4128), including any documentation that was required as a result of findings made during Pre-Application processing.

B. 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 property 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. 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 REL

g. Estimate of Interest during Construction (line 53 in section g of Form HUD-92264), to be calculated as the greater of:

   (1) 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)

   (2) 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 3. HUD's review appraisers have the option to modify appraisal conclusions internally or to return the application to the Lender for modification. See Chapter 11 Section 11.2 for review by MF Hub/PC staff.

6. The Lender must provide written explanations in the underwriter's narrative of any major changes to the pre-application invitation letter.

7. 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.

C. HUD Review:

1. The Lender must submit the Exhibits listed in Section 7.10.A.

2. The HUD appraiser must perform a thorough technical review of the appraisal submitted for the project, making sure that it meets the requirements of Section 7.5 including all USPAP requirements.

3. The HUD appraiser must complete Form HUD-4128 and the Sample Field Notes Checklist, if not already completed at the pre-application stage.

4. The HUD appraiser must review and approve each of the following exhibits:

   a. Rental Housing Project Income Analysis and Appraisal, HUD-92264

   b. Estimates of Market Rent by Comparison, HUD-92273 (updated)

   c. Operating Expenses Worksheet, HUD-92274 (updated)

d. Supplement to Project Analysis, HUD-92264-A

Within these forms, the HUD review appraiser must approve, reject, or approve with required modifications the estimated income, the total operating expenses, the total estimated replacement cost, the “Warranted Price of the Land” or the "As Is" value as appropriate and other major items.

5. The HUD review appraiser must issue a written report containing recommendations and forward a copy to the team leader.
6. The HUD review appraiser must review the Underwriting Summary, including justifications of discrepancies between the Lender’s and the appraiser’s conclusions.

7.12 Firm Commitment Processing for Section 223(f)

A. Exhibits:

1. Application for Multifamily Housing Project, Form HUD-92013
2. Location map
3. Evidence of permitted zoning
4. Evidence of site control (deed, purchase agreement, option)
5. Evidence of last arms-length transaction and price
6. Phase I ESA with a narrative environment report. A Phase II ESA must also be submitted, should the Phase I ESA disclose a need for further study. This requirement applies to all 223(f) programs and 202 (202/223(f)).
7. Appraisal
8. Rental Housing Project Income Analysis and Appraisal, HUD-92264
9. Supplement to Project Analysis, HUD-92264-A
10. Estimates of Market Rent by Comparison, HUD-92273
11. Operating Expenses Analysis Worksheet, HUD-92274
12. Balance sheets and operating statements
13. Rent roll of the subject property
14. PCNA

B. Lender's responsibilities:

1. The Underwriting Narrative must demonstrate that the MAP Underwriter performed adequate due diligence in reviewing the appraisal including a thorough discussion by the Underwriter of the appraiser's market analysis with a comparison made 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.

   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 what was actually used in underwriting the loan. The appraiser's value conclusions may be adjusted downwards by the Underwriter but may not be adjusted upwards.

2. The appraiser must complete an appraisal of the property 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.

3. The appraiser should where practicable participate in the inspection of the property with the Needs Assessor as described in Appendix 5G. 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.

4. The appraiser must analyze the property for acceptability.

5. The Lender must have the Phase I ESA and narrative report prepared.

6. The Lender must assure that forms HUD-92273, Estimate of Market Rents and HUD-92274, Operating Expense Analysis Worksheet, are completed. 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 property (rent roll and financial statements).

7. 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.

8. 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 and replacement reserve
    g. Estimated and actual occupancy rate
    h. REL

9. The data provided in the Lender's HUD-92013 and 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.

10. The Lender must assure that the Remarks Section of HUD-92264 contains the following information:

    a. The appraiser's statement of actual occupancy, based on the owner's rent roll.
    b. The required amount of initial deposit into the Reserve for Replacement.
    c. The estimated cost of required repairs as provided in the inspection report.
    d. The estimated amounts for legal, organizational (if applicable), title and recording expenses based on the maximum insurable loan.

C. HUD review:

1. The Lender must submit the Exhibits listed in Section 7.12.A.
2. The HUD review appraiser must perform a thorough technical review of the appraisal submitted for the project.
3. The HUD appraiser must inspect the subject site and as many of the comparables as feasible, that were supplied by the appraiser. At this visit, the HUD appraiser will also review the borrower's proposed list of critical and non-critical repairs and provide an opinion of the acceptability of the list based upon the HUD appraiser's potentially limited knowledge of construction. The HUD appraiser may consult with a HUD construction analyst when formulating the opinion.
4. The HUD appraiser must complete Part A of HUD-4128.

   The HUD appraiser must review the recommendations of the HUD architectural analyst and the HUD-92264, and must review property characteristics and, based on these reviews and the environmental analysis, must make a recommendation of site acceptability.
5. The HUD appraiser must review and approve each of the following Exhibits:

   a. Rental Housing Project Income Analysis and Appraisal, HUD-92264
   b. Estimate of Market Rent by Comparison, HUD-92273
   e. Operating Expenses Worksheet, HUD-92274

   The HUD review appraiser must approve, reject, or approve with required modifications of major items including the estimated income, the total operating expenses, the total estimated replacement cost, the estimated REL, the maximum insurable mortgage and the market value of the project.
6. The HUD appraiser must review the Underwriting Summary for justifications of discrepancies between the Lender's and the appraiser's conclusions.
7. The HUD appraiser must review the Underwriting Summary to determine if the Lender's underwriter carried out a "due diligence" review of the appraisal.

8. The HUD appraiser must issue a written report containing recommendations and forward a copy to the team leader.

7.13 Substantial Rehabilitation Processing for Sections 220 and 221(d)(3), 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) 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 HUD-92273 and HUD-92274 analysis used to support the income and expenses on the HUD-92264 must reflect the “as completed” property 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 HUD 92264.
4. The “as is” value and the value of the land without improvements must be entered in Section “O” (Remarks) of the 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. The Market Value by the market comparison approach will be based upon market prices for comparable properties in similar condition to the project being appraised. The income approach may not be feasible for the valuation of properties in extremely poor condition or are mostly or entirely vacant, boarded up or abandoned for an extended period to time.

D. Valuation Processing: (Sections 220, 221(d)(3), 221(d)(4))

1. Determine the market value of the property "As Is". Complete the Location and Description of the Property, Information concerning Land or Property, 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 property, 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 property before rehabilitation will be shown on the line titled "As Is" value of property.
4. "As Is" value of property acquired as a leasehold estate. Instructions for limiting the "As Is" value of property before rehabilitation, when that property is acquired as a leasehold estate, are found in Ground Leases, Section 7.16.
5. To find the project mortgage amount for Section 220 and Section 221, use the lower of Criteria 1, 3, 4, or 5 on HUD-92264-A. Estimate the "As Is" value of the property 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 90 percent based upon Criterion 3 to obtain the maximum project mortgage amount. Under the Section 221(d) (3) program for nonprofit borrowers, multiply 90 percent against the sum of the project's cost.

E. Valuation Processing for Section 231 Substantial Rehabilitation Cases. Section 231 substantial rehabilitation cases requires 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, line73b 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) (3 & 4). Depreciation is not included. The "As Is" value is also used in completing Criterion 6 of the Form HUD-92264-A.

   If the Total Estimate 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. 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 percent 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.

G. Interest during Construction. Interest during construction (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 with a pro-forma draw schedule or equivalent.

H. 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 (plus BSPRA, if applicable), rounded to the next higher $100, times .5 percent.

I. 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.

J. 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.

K. 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. These instructions do not apply to the refinancing of Section 202/811 projects.

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.

L. 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 developers fee noted above.

7.14 Calculating Operating Deficits

A. Estimate a project's operating deficit, if any, in its early years if required by the applicable insurance program. A project which cannot rent-up to sustaining occupancy in the first years must be carefully examined and may not be financially feasible to fund. However, if it takes time to move residents into a large project, then it is likely that the average overall occupancy percentage for the first year will be less than the break-even percentage. 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 property 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. This assumes a typical pre-marketing period; prior to the issuance of the certificate of occupancy, of about three to six months and 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. Previously, HUD had allowed absorption periods of up to 24 months. Due to volatility and weakness in the real estate markets, the absorption period used in estimating market demand for the proposed number of units now must be restricted 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 considered by waiver granted by the Hub 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, continue through the cost certification phase, and run into 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 period of time between certificate of occupancy and the end of the construction period/cost certification period. (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 since Section 7.16.G, requires ground rent during the construction period to be included in the mortgage. 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 8.5.A 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 property 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.

5. 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.
6. 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.
7. 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.

B. Where commercial facilities are included in the project, a separate analysis must be made of the effect that the commercial operation will have on the project expense estimate. A separate operating deficit estimate of income loss for commercial rent-up must be made. 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 property. 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 Ground Leases

A. HUD prefers to only insure mortgages for land that is owned in fee simple. For those transactions, in which fee simple ownership is not practical, the underwriting and valuation guidance in this section applies.

B. When used in this section, the words below are defined as follows:

1. Fee Simple Estate. This represents the entire ownership, from beneath the soil to the air above, enduring by inheritance and indefinitely into the future.
2. Lease. A lease is a written contract between an owner (the lessor) and a resident (the lessee) with the conditions under which the lessor will transfer the use of real property to the lessee in return for lease payments or rent.
3. Ground Lease. A long term agreement by which an owner of land (lessor) leases an unimproved site to a resident (lessee) for a term of years that is long enough to enable the lessee to construct a building on the leased site and obtain a permanent mortgage.
4. Ground Rent. Payments on a ground lease are called ground rent and must bear a reasonable relationship to the value of the site "As Is" (before construction of on-site or off-site improvements) unless the ground lease is from a governmental agency which has made the ground lease available for limited ground rent to support the development of affordable housing.
5. Leasehold Estate. The interest of the lessee under a ground lease for a term of years is called a leasehold estate. When the term of the lease expires, all rights to possession and use revert back to the lessor/fee simple owner and the leasehold estate terminates.
6. The Leased Fee. The interest of the lessor/ fee simple owner during the period when the property is under lease.
7. In computing payments due under the lease, the terms “gross collections,” “operating expenses and taxes,” “net income before debt service payments” and “net cash flow” shall be defined as follows:
   a. Gross collections (or effective gross income) shall mean the annual amount collected from all sources, less refunds.
   b. Operating expenses (residential and commercial) and taxes shall be composed of items in accord with generally accepted accounting principles. However, for lease payment computations, taxes shall not include income taxes, and 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 at the project which are necessary to the operation of the project. Operating expenses must include the annual amounts deposited to the Reserve for Replacement.

c. Net income before debt service payments shall mean the annual amount which remains after operating expenses and taxes are subtracted from effective gross income.

d. Debt service payments shall be the annual amounts paid to mortgage principal, interest, and MIP.

e. Net cash flow shall be the annual amount remaining after debt service payments are subtracted from net income.

C. Term of Lease. Leaseholds must conform to the Lease Addendum Form HUD-92070M. The term of the Lease Addendum may vary to conform with applicable state and local law, except that the HUD closing attorney must approve:

1. The legal need for any proposed lease term changes, and

2. That any term changes are consistent with the following requirements of the Section of the Act under which the project is underwritten:

a. Section 207/223(f) and Section 231 sub-rehabilitation. The lease term must satisfy one of the following requirements:

(1) Term must be 99 years and be renewable, or

(2) Term must be at least 50 years from the date the mortgage is executed. (When a lease is on trust/other land on a reservation, the HUD closing attorney must ensure that the lease provisions are coordinated with Bureau of Indian Affairs requirements).

b. Section 220, 221(d), and 231 (new construction only). The lease term must satisfy one of the following requirements:

(1) Term must be 99 years and be renewable, or

(2) Term must have at least 10 years remaining after the maturity date of the insured mortgage.

D. Marketability. The marketability of a rental project is based primarily on an investor's estimate of the present value of future cash flows. If a ground lease increases the project cash flow and the return on equity, investors will consider the property's marketability to be enhanced. However, the leasehold estate cannot be considered marketable unless the lease meets the requirements described of this section.

E. Regulation for Leaseholds. HUD regulations state "Reduced mortgage amount - leaseholds. In the event the mortgage is secured by a leasehold estate rather than a fee simple estate, the value or replacement cost of the property described in the mortgage shall be the value or replacement cost of the leasehold estate (as determined by HUD) which shall in all cases be less than the value or replacement cost of the property in fee simple."

F. Legal Review. The ground lease must receive both a legal review and a Lender underwriting review, neither of which may be substituted for the other. Legal review, performed by the HUD legal counsel, shall establish that the proposed lease is in conformity with the applicable statute, regulations, Form HUD-92070M (the Lease Addendum model form), and applicable provisions of local law. Any substantive deviations from Form HUD-92070M must be approved by Headquarters' Office of Multifamily Housing Development.

G. Underwriting Review of Lease at Firm Commitment. In testing the lease payments for acceptability, the appraiser must take the following actions:

1. The appraiser must perform a Firm Commitment review to develop the following estimates:
   a. Market value of land fully improved (in fee simple)
   b. Warranted price of site fully improved (in fee simple)
   c. Value of site "As Is" (in fee simple)
   d. Gross income
   e. Effective gross income
   f. Total operating expenses and taxes
   g. Net income
   h. Replacement cost by formula
   i. Value of project (in fee simple) if applicable
   j. Mortgage amount, by completing a valuation trial copy of Form HUD-92264A. (The value of the leased fee equals the value of site "As Is" in fee simple, before construction of on-site or off-site improvements.) The HUD-92264A may be completed by the Lender.
   k. Annual debt service payments to principal, interest and MIP.
   l. Annual cash flow (after debt service payments but before ground lease payments)

2. The appraiser must analyze the lease provisions that determine the amount of annual ground rent payments. Although certain kinds of ground rent payments will be permitted that increase over time, this must be accomplished without weakening the tests which are designed to assure that the position of the borrower and of the insured mortgage secured by the leasehold would be no worse than if the property were held in fee.
   a. Some variable lease payments may not be acceptable because they raise the risk that future payments may be too burdensome and may cause a potential default in the mortgage payments. Examples of unacceptable methods of determining variable ground rents are:
      (1) A graduated schedule of future increases on a lump sum year-by-year basis.
      (2) Cost of Living Allowance (COLA) increases.
      (3) Increases based on the results of future appraisals.

b. To determine if the initial amounts are within underwriting limitations, ground rents may be computed using any of the following three methods:

(1) A fixed percentage of gross collections (or effective gross income). The percentage must remain the same throughout the term of the lease.

(2) 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.

(3) A stated dollar amount per year which must remain fixed for at least ten years more than 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 lease payments, 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.

3. The appraiser must estimate the lease payments, using the lump sum annual amounts and percentages contained in the lease provisions, as applied to the estimated annual effective gross income or annual cash flow indicated by the appraisal and on Form HUD-92264. (The estimates are not based on the income which would be available during any period of deficit operation, but must reflect the effective gross income shown on Form HUD-92264 and the corresponding cash flow to equity which result when sustaining occupancy has been reached.).

4. Example: Assume the facts are as shown in the following example:

LAND VALUE

Warranted Price of Land Fully Improved (In Fee Simple) .... $ 125,000
"As Is" Value of Land (In Fee Simple) 115,000
Value of Leased Fee 115,000

Income and Cash Flow

Estimated Effective Annual Gross Income, All Sources................................. $ 242,455
Estimated Total Annual Expense (incl. Replace. Res.)...................................... 120,500
Estimated Net Income (before mortgage payments).. 121,955
Annual Mortgage Payments (principal, interest, MIP) 99,661
Estimated Annual Cash Flow to Equity (before ground rent).............................. 22,294

Estimated Replacement Cost and Mortgage Amount

Estimated Replacement Cost (or Value) of Project
(In Fee Simple)... $1,250,000
Estimated Value of the Leased Fee 115,000

Estimated Replacement Cost (or Value) Of Project (leasehold Estate) ……..1,135,000

Maximum Mortgage Amount from Form HUD-92264-A

(Leasehold Estate) $1,021,500 ($1,135,000.00 x .90)

Annual Ground Rent Required

Assume that provisions of the lease require annual lease payments to equal the greatest of the three following calculations:

a. Three percent (3%) of annual gross collections ($242,455) =$7,274;

b. Twenty percent (20%) of annual net cash flow to equity ($22.294) = $4,459

c. Seven Thousand Dollars ($7,000.00) per year minimum.

The appraiser notes that the amount of initial ground rent required by the lease is the greatest of these three amounts: 3% of annual gross collections, or $7,274. This amount is next tested to determine whether it is within permissible limits:

a. 3% of annual gross collections ($242,455) = $7,274

b. 20% of annual net cash flow ($22,294) = $4,459

c. $7,000 per year, minimum = $7,000

The appraiser must note that the amount of initial ground rent required by the lease is the greatest of these three amounts: 3% of annual gross collections, or $7,274. This amount is then tested to determine whether it is within permissible limits.

5. Test for Acceptability of Variable Lease Payments. In the above example, the appraiser has determined that the amount of the initial annual ground rent required by the lease is acceptable.

Except for level lease payments, the annual ground rents must not exceed the value of the site "As Is" in fee simple ($115,000) multiplied by 90% of the interest rate of the insured mortgage (.90 x .09 = .081).

The following is an example of the Test for Acceptability of Variable Lease Payments:

$7,274 based on the estimate of annual gross collections (effective gross income) used in the appraisal. Thus $115,000 x .081 = $9,315. The ground rent ($7,274) is less than ($9,315) the value of the site "As Is" multiplied by 90% of the interest rate of the insured mortgage; therefore, the annual rent is acceptable.

6. Form HUD-92070M, 207 Lease Addendum. The appraiser must review other provisions of the lease (other than those concerned with annual lease payments) to determine that they will not restrict the successful operation of the project, keeping in mind that the provisions of Form HUD-92070M, the 207 Lease Addendum, must be included in, or legally appended to, the lease. The proposed lease must not contain any provisions in conflict with the lease addendum. If the above conditions are met and the annual lease payments required under the lease meet the test for acceptability, the appraiser may recommend that the lease be accepted.

7. Test for Acceptability of Level Lease Payments. The lease may only require annual ground

rent payments that are a stated dollar amount per year which must remain fixed for at least 10 years more than the term of the insured mortgage. A lease may require payments that are a stated dollar amount, but may not require payments of a fixed percentage of gross collections or a fixed percentage of net cash flow (after mortgage payments but before ground lease payments). In such cases, the amount of stated annual ground rent will be acceptable if it does not exceed the value of the site "As Is" multiplied by 100% of the interest rate of the insured mortgage.

8. Processing Single, Up-Front Payment (SUP) Leases. In ground lease cases where there is an up-front, single payment of ground rent, the ‘As Is” value of the land in fee simple is to be subtracted from the property value in Criterion 3 (Line B-1 identified as “value of the leased fee”) and is not to be included in the mortgage. SUP leases are treated as any other leased fee because they do not include all of the rights of fee simple ownership.

H. Ground Rent during Construction. For proposed construction under all sections of the Act, lease payments during construction must be included in the estimated replacement cost of the project and in the certified cost, subject to the following conditions:

1. 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.
2. 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.
3. Ground rent must not be included in the base on which Section 220, 221(d) BSPRA is calculated.
4. The annual amount of ground rent during construction may not exceed the test for acceptability of lease payments.

I. Replacement Cost by Formula

A formula will provide the total project replacement cost and mortgage amount, based on the cost for proposed construction, where a leasehold estate is involved. This formula provides for Sections of the Act which use or which do not use BSPRA. A separate formula is necessary for leasehold properties because the mortgage amount is less than it would be if no ground lease were involved.

J. Value of the Leased Fee

1. The procedures for estimating the value of the leased fee consist of the following general rule and two exceptions:

a. General Rule. Except as provided below, the value of the leased fee must be estimated to equal the market value of the site "As Is" in fee simple regardless of whether the ground rent is an escalating amount based on a percentage of gross collections or cash flow, or whether it is a level stated dollar amount each year.

(1) The value of the leased fee, so estimated, must be entered in the appropriate space in line K-6, Form HUD-92264.

(2) The annual ground rent, based on the lease provisions and estimates of income and expense used in the appraisal, must be entered in the appropriate space in line K-6, Form HUD-92264.

(3) Dividing the ground rent by the value of the leased fee will result in the earning rate indicated by this ground rent. This rate must be entered in line K-6.

b. Exception for Leases Containing an Option to Buy. In cases that meet the following conditions, the value of the leased fee may be estimated by capitalizing the ground rent.

(1) The lease must give the lessee an option to buy the site in fee simple for a stated purchase price at some time during the term of the lease. This stated purchase price must be provided in the ground lease and may not exceed the value of the fee estimated by the capitalization method of value at the time of property appraisal.

(2) The annual ground rent required by the lease must be level payments of a stated dollar amount and must remain unchanged from the date of mortgage endorsement to at least ten years after the mortgage term.

(3) A market capitalization rate must be used which may not exceed the interest rate of the insured mortgage. The ground rent divided by the capitalization rate results in the estimated value of the leased fee to be entered in line K-6, Form HUD-92264.

K. Option Price for Assistant Secretary for Housing–Federal Housing Commissioner. The ground lease must contain an option for the Assistant Secretary - Federal Housing Commissioner to buy out the lease. The option price contained in the lease addendum must reflect the value of the leased fee in Form HUD-92264.

L. Ground Leased from Public Bodies. On sites leased by a governmental body to a developer for use for a specific purpose, the procedures outlined in this chapter remain unchanged, except that the "As Is" market value of the site in fee simple (before construction of on-site and off-site improvements) may not exceed the value of the leased fee.

M. Rehabilitation of an Existing Leasehold Project. When a leasehold estate contains existing buildings and is to receive an insured mortgage for substantial rehabilitation, valuation processing will vary from fee simple rehabilitation processing as follows:

1. "As Is" Value of Entire Property, Land, and Buildings
   a. Tentative "As Is" value of both land and building(s) must be established by capitalization of income and by comparable sales.
   b. Value of the land without building improvements must be made by market comparison based on sales of similar sites.
   c. Acquisition Cost of Buildings. The maximum ground rent must be limited by the value of the land without the buildings multiplied by 100 percent of the mortgage interest rate for level ground rent payments, or multiplied by 90 percent of the mortgage interest rate for acceptable escalating payments. Since the value of the land without improvements does not include buildings, the cost of the acquisition of the buildings will be whatever added cash amount the buyer pays the seller of the subject property for the buildings, at or before initial closing. A certificate of the separately agreed amount for purchase of the buildings must be submitted with the application exhibits. In a refinancing loan which does not involve a buyer and seller, the cost of the buildings may not exceed the remaining mortgage balance.
   d. Final “As Is” value of entire property is the lesser of Section 7.15.M.1.a or the sum of Sections 7.15.M.1.b and 7.15.M.1.c.
2. Value of the Leased Fee. This value will be the amount shown in Section 7.15.M.1.b, Value of Land without Building Improvements.
3. Term of Ground Lease. The term of the ground leasehold must comply with Section 7.15.C above.
4. Value of the Leased Fee. The value of the leased fee must be estimated to equal the value of the site in fee without the on-site improvements and is entered on Line K-6 of Form HUD-92264.
5. Underwriting Review of Lease. The appraiser must follow Section 7.15.H to determine whether the annual ground rental is acceptable.
6. Lease Addendum. Form HUD-92070M must be included in, or appended to and made a part of the lease. The appraiser must review all lease provisions (in addition to those concerned with annual lease payments) to determine that they will not restrict the successful operation of the project. If the above conditions are met and the annual lease payments meet the test for acceptability, the appraiser may recommend that the lease be accepted.
7. Ground Rent during Construction. For rehabilitation under all Sections of the Act, ground rent during rehabilitation must be included in the replacement cost and meet the requirements of Section 7.15.H.

8. Replacement Cost by Formula. A formula that will provide the total project replacement cost and mortgage amount, based on cost for substantial rehabilitation wherein a leasehold estate is involved. This formula provides both for sections of the act which recognize and which do not recognize BSPRA.

7.16 Tax Abatement Procedures

A. General Comments and Exceptions. Tax Abatement is a reduction of property taxes for a specified term by the taxing authority. Properties with abatement are eligible for additional mortgage funds under certain circumstances. <u>The abatement must run with the real estate and not with the type of sponsorship if it is to secure additional mortgage proceeds, otherwise underwriting must include an amount for property taxes in project operating expenses even if the present owner or its transferee may not pay them.</u> The risk that a transferee of the property 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 financing includes LIHTC equity and if the tax abatement runs with the sponsorship (borrower) entity, then the Hub Director may waive the MAP Guide so that the underwriting does not have to include a provision for property taxes, during the period of the tax abatement. This exception is justified for low loan-to-value mortgages on LIHTC projects.
2. Properties leased from a governmental body to either a non-profit or for-profit developer, where the property 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. Hub Directors may grant a waiver, after appropriate review, to promote affordable housing.

B. Long 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 property 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 property 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 reduced 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.

C. Short Term or Variable Tax Abatement. If the abatement is short 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 short term or variable abatement, the full amount of the property 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.

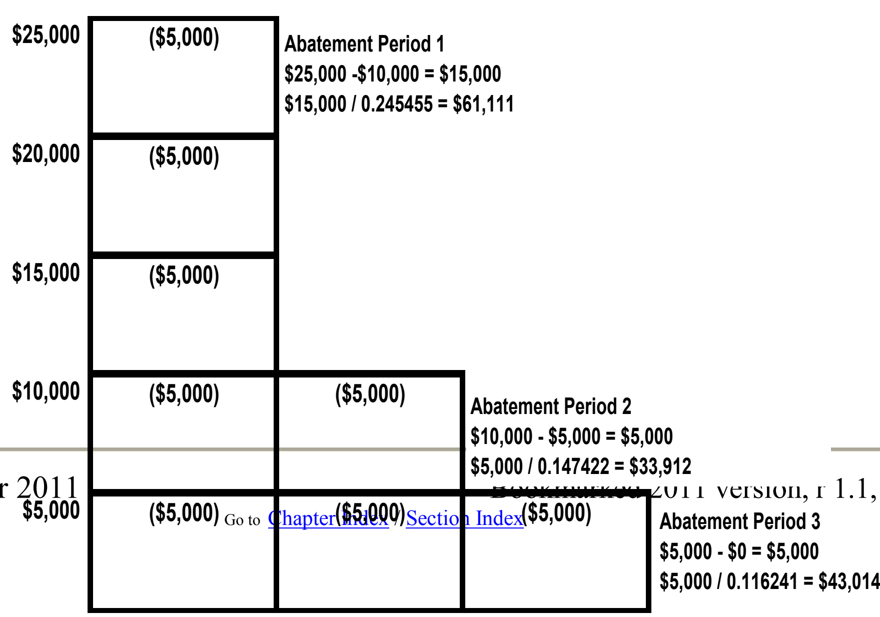
If Criteria 5, "Amount Based on Debt Service Ratio" is not the controlling criterion, short term or variable abatements cannot be used to secure additional mortgage proceeds. Also, the appraiser must not include extra value associated with short-term abatement in either the estimate of land value, the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

1. Short Term Abatements: Assume that Property 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 rate (P, I, and MIP). In this example the debt service rate is 0.245455383.

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

   Additional mortgage amount. The mortgage amount based upon debt service (Criteria 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 Property 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.

(1) Abatement Period 1

$25,000 minus $10,000 (the amount of abatement in period 2) = $15,000 for 5 years. The debt service rate 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.

(2) Abatement Period 2

$10,000 minus $5,000 (the amount of abatement in period 3) = $5,000 for 10 years. The debt service rate 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.

(3) Abatement Period 3

$5,000 minus $0 (since there are no periods remaining) = $5,000 for 15 years. The debt service rate 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.

(4) 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 through10, and $5,000 per year in years 11 through 15.

7.17 Project Based Section 8 and LIHTC Processing

A. For Section 223(f). The property must be evaluated under two scenarios: a) the "hypothetical market value" of the property without regard to any Section 8 project based subsidies, rent restrictions or LITHC, 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. Criteria 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 Criteria 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. Criteria 5 Debt Service Analysis: In calculating net operating income to be used for Criteria 5 Debt Service, rent restrictions must be observed. For the Criteria 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. 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 property 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 property 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 property has different expense needs as a subsidized property, the expenses used for Criteria 3 must be market rate expenses and the expenses used for Criteria 5 debt service shall be the actual expenses under its' proposed usage. This will insure that the Criteria 5 - debt service analysis of the HUD 92264a is calculated based on the actual estimate of the rent restricted NOI for the property.
3. Audit Fee no Longer Recognized. With the elimination of the requirement for an audited cost certification for mortgage insurance transactions with LIHTC, assuming the ratio of loan proceeds to the actual cost of the project is less than 80 percent, the audit fee will no longer be recognized as an allowable cost in the Total Estimated Replacement Cost of Project, Section G line 66 Form HUD-92264.

D. Sections 220 and 221(d) Site Value and "As Is" Value:

The site value of land in new construction or the "As Is" value in substantial rehabilitation cases is to be estimated using a capitalization rate and property NOI as if the units and the property were unrestricted and market rate, without considering: a) any additional value that may be attributable to subsidies available to the project or any LIHTCs or other tax benefits the property 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 property 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.

E. Income Limits. The review appraiser 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. For LIHTC, HERA defines area median income in rural areas as the greater of the area median income and the national non-metropolitan median income, effective for income determinations made after date of HERA enactment, as applicable only to 9 percent LIHTC developments.