



U.S. Department of Housing and Urban Development
Community Planning and Development

Special Attention of:
CPD Division Directors
All HOME Coordinators
All HOME Participating Jurisdictions

Notice: CPD-15-11

Issued: December 22, 2015
Expires: **This NOTICE is effective until it is amended, superseded, or rescinded**

Cross Reference: 24 CFR Part 92

Subject: Requirements for the Development and Implementation of HOME Underwriting and Subsidy Layering Guidelines

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I. PURPOSE

The purpose of this Notice is to provide guidance to HOME participating jurisdictions (PJs) in the development and implementation of written subsidy layering and underwriting guidelines in accordance with the HOME regulations at 24 CFR Part 92. A PJ is required to develop and use such guidelines to evaluate and ensure that the level of HOME investment does not exceed the amount that is necessary to provide quality affordable housing that is financially viable.

II. APPLICABILITY

The underwriting and subsidy layering requirements at §92.250 are applicable to projects for which HOME funds are committed on or after August 23, 2013.

This Notice is applicable to all rental projects developed in whole or in part with HOME assistance. For projects which are only partially funded by HOME, the PJ must assess the financial viability of the entire project, not just the HOME-assisted units.

This Notice is also applicable to HOME-assisted projects which seek to develop and sell units to homebuyers, whether scattered site or within a designated subdivision or target area. The regulations at §92.2 define a HOME “project” as a site or sites together with any building under common ownership, management, and financing and assisted as a single undertaking. The project includes all the activities associated with the site and building.

While the underwriting requirements of Part 92 generally apply to all HOME-assisted projects, there are some activities for which not all elements of the underwriting analysis are required:

- For **direct homebuyer assistance** which is not part of a HOME-funded development activity and for **homeowner rehabilitation assistance** activities when the HOME loans are amortizing, the general project underwriting and subsidy layering requirements of §92.250 will apply. Section §92.254(f) requires a PJ to develop underwriting standards as part of the program policies for direct homebuyer assistance. Under §92.3, the requirements at §92.254(f) are applicable to projects for which HOME funds are committed on or after January 24, 2014.
- For HOME-funded direct homebuyer assistance that is not part of a HOME-funded development activity, the underwriting guidelines at §92.254(f)(1) apply, but:
 - A market analysis is not required; and
 - An evaluation of developer capacity is not required.
- For homeowner rehabilitation activities:
 - Underwriting the homeowner’s ability to make mortgage payments is required only if the HOME-funded rehabilitation loan is an amortizing loan;

- A market analysis is not required; and
- Evaluation of developer capacity is not required as a developer is not involved.

III. BACKGROUND

For purposes of the HOME program, underwriting involves the analysis of project assumptions and risks to determine if the public investment is reasonable and the project can be expected to meet all applicable program requirements during the period of affordability. Subsidy layering is a component of project underwriting, which involves assessing whether the proposed level of HOME assistance is appropriate given the level of project investment by other financing sources. This notice covers both the HOME underwriting requirements and the subsidy layering analysis, which forms the basis for the detailed evaluation of the prudent investment of HOME funds.

A. STATUTORY AND REGULATORY REQUIREMENTS

Section 212(f) of the Cranston-Gonzalez National Affordable Housing Act of 1990 (NAHA), as amended, requires a PJ to certify that it will not invest any more HOME funds in combination with other governmental assistance than is necessary to provide quality affordable housing that is financially viable for the period of affordability required in §92.252 or §92.254. The 2013 HOME Final Rule (“HOME Rule”) establishes the requirements for underwriting guidelines to govern the PJ’s decision regarding investment of HOME funds in all projects:

- **§92.250(b)** requires the PJ to adopt and evaluate projects according to written underwriting and subsidy layering guidelines for all HOME activities to determine the appropriate HOME investment. These guidelines must require the examination of project sources and uses, cost and profit reasonableness, market demand, developer experience and capacity, and financial commitments.
- In addition, **§92.254(f)** requires the PJ to adopt and follow written underwriting standards for assistance to homebuyers, including analysis of housing and family debt, monthly family expenses, assets available to acquire the housing, resources needed to sustain homeownership, including the terms of planned mortgages.

B. RELATED HOME REQUIREMENTS

In addition to the requirements stated at §92.250 and §92.254, there are several other types of requirements which affect the underwriting of HOME-assisted projects that must be taken into account when determining and documenting the appropriate level of HOME assistance.

- 1) **Maximum per unit subsidy limits (§92.250):** The amount of HOME funds that a PJ may invest on a per-unit basis in affordable housing may never exceed the per unit dollar limits for elevator-type projects that apply to the area in which the housing is located. For information on maximum per unit subsidy limits, see [CPD](#)

[Notice 15-003](#) or successor notices. These limits will vary by the number of bedrooms in a unit; a published listing is available from the HUD Field Office. The maximum subsidy limits apply to all HOME-assisted units. Under no circumstances may the level of per unit HOME investment exceed the maximum subsidy limits; therefore, underwriting cannot be completed without knowledge of these limits. Also, §92.205(c) imposes a minimum subsidy of \$1,000 per unit.

- 2) **Cost allocation (§92.205(d)):** The HOME Program permits the funding of one or more units in a project, including mixed-income and mixed use properties. However, HOME funds may only be used to pay eligible costs for HOME-assisted units. When a PJ designates fewer than 100% of a project's units as HOME-assisted, the PJ must calculate the eligible costs that are allocable to the assisted units and may only pay the actual costs related to those HOME-assisted units, capped by the maximum subsidy limits described above. Thus, cost allocation requirements affect project underwriting by dictating either the maximum amount of HOME investment a PJ may provide, or the minimum required number of units that must be designated as HOME-assisted.
- 3) **Written agreements (§92.504):** A PJ must execute a written agreement before disbursing HOME funds to any entity, including developers and owners of rental and homebuyer housing. The written agreement must capture the project and financing terms that result from the underwriting process.
- 4) **Commitment (§92.2):** HOME funds are not committed to an identifiable project until the parties execute a legally binding written agreement. A PJ cannot commit funds to a project until all necessary financing is secured, the underwriting and subsidy layering described in this notice has been completed, and construction can be expected to begin within 12 months. The commitment date is especially important because all HOME funds must be committed within 24 months of the grant award (§92. 92.500(d)(1)(B)). Thus, the PJ must have an efficient process for soliciting and reviewing proposed projects. For information on maximum per unit subsidy limits, see [CPD Notice 15-09](#) or successor notices.
- 5) **HOME deadlines:** The HOME program imposes several additional regulatory deadlines that may affect the underwriting process:
 - **Acquisition/demolition (§92.2):** When reviewing the development and marketing plan submitted by the applicant, the PJ must ensure that any acquisition of standard housing will occur within six months of the contract or purchase agreement date, and construction, or demolition of the property is scheduled or reasonably can be expected to start within 12 months of the agreement date.
 - **Project completion (§92.205(e)(2), §92.2):** The PJ must complete the projects within four years of the date funds are committed to the project. Therefore, the underwriting analysis and project plan must ensure that funds are available and construction is scheduled within this timeframe.

- **Lease-up (§92.252):** If a HOME-assisted unit is not occupied by an eligible tenant within six months following project completion, the PJ must report status and marketing efforts to HUD. If the unit remains unoccupied at 18 months after the project completion date, HUD will require the PJ to repay the HOME funds. Thus, the PJ must carefully assess the market study and the project plan to ensure that there is documentation of sufficient demand for the proposed units.
 - **Homebuyer unit sale (§92.254(a)(3)):** For homebuyer development projects subject to the HOME Rule, if there is no ratified sales contract within nine months of the construction or rehabilitation completion, the ownership unit must be converted to HOME-assisted rental housing pursuant to §92.252. For homebuyer development projects subject to the 2012 or 2013 Appropriations requirements (P.L. 112-55) and (P.L. 113-6), there must be a ratified sales contract within six months of the construction or rehabilitation completion. As a component of the underwriting process, the PJ must carefully review the project development, market study and sales plan submitted by the developer to ensure that there is sufficient demand for the homeowner units to meet these timelines.
- 6) Property standards (§92.251):** All properties assisted with HOME funds are subject to minimum property standards at project completion. In addition, rental projects are subject to property standards throughout the affordability period. When reviewing a budget as part of the project underwriting, the PJ must ensure that all costs are eligible and the resulting housing units will meet the established property standards. In addition, for projects that provide 26 or more units the PJ must complete a capital needs assessment (§92.251(b)(1)(ix)).
- 7) Rents/utility allowance (§92.252(a)):** HUD publishes the maximum rent that may be charged in HOME-assisted units, depending on the number of bedrooms and project location. HOME rent limits include either actual utilities or a utility allowance. The underwriting process must cap HOME-assisted units at these rent limits and demonstrate that the project will be financially viable on this basis.
- 8) Affordability period (§92.252(e), §92.254(a)(4)):** All HOME-assisted rental and homebuyer projects are subject to an affordability period, depending on the type and amount of investment. As a part of the underwriting process for rental projects, a PJ must ensure that projects will remain financially viable and the assisted units will meet the property standards and affordability requirements for not less than the applicable affordability period, beginning at project completion.

IV. UNDERWRITING POLICIES AND PROCEDURES

Under the provisions of §92.250(b) of the HOME Rule, a PJ may not invest any more HOME funds, alone or in combination with other governmental assistance, than is necessary to provide quality affordable housing that is financially viable through the affordability period (see §§92.252 or 92.254). In addition, the PJ must ensure that the return to the owner or developer is reasonable and does not exceed the PJ's established standards based on the size, type and complexity of the project.

To implement this requirement, the HOME Rule requires that develop and use written guidelines to underwrite each project. As previously mentioned, the PJ's underwriting and subsidy layering policies and procedures must, at a minimum, include:

- An examination of the sources and uses of funds for the proposed project and a determination that all project costs are reasonable;
- An assessment of the current market demand in the area where the project will be located;
- An assessment of the experience and the financial capacity of the developer or rental project owner; and,
- An assessment of the firm written financial commitments for the project.

The PJ is required to evaluate a project using its underwriting and subsidy layering guidelines before committing HOME funds and is responsible ensuring that underwriting is revised in response to any changes that may occur in the project budget. The PJ must be able to demonstrate it has independently evaluated the project budget, financing and development schedule. To confirm that this has occurred, the PJ is required to certify in HUD's Integrated Disbursement and Information System (IDIS) that it has followed its underwriting and subsidy layering standards before making a commitment of HOME funds. It is important that a PJ re-check and update the project underwriting at:

- Initial Closing or construction start, since construction costs at the time of project application typically are estimates instead of firm bids and contracts; Before HOME funds, in addition to the original commitment, are awarded to the project during development (e.g. in response to a change order or other changes in project costs).
- Construction completion or final draw, when final sources and uses can be verified;

While a PJ is ultimately responsible for the project underwriting, it may permit a subrecipient, State recipient or contractor working for the PJ to perform underwriting functions or services. However, the PJ must retain full review authority and must certify in IDIS to the use of its underwriting standards. The use of subrecipients, State recipients, or contractors does not relieve the PJ of its responsibility to provide for proper levels and types of investment with HOME funds.

The PJ may also choose to review the underwriting of other lenders. However, the PJ must still

make and document its own determination that the project meets HOME requirements, is compliant with the PJ's written underwriting and subsidy layering standards, is a reasonable investment, and is likely to remain financially viable throughout the HOME affordability period.

Although a project that combines HOME and LIHTC funding may have been underwritten by the state credit allocating agency, the PJ must still review and document compliance with its own underwriting and subsidy layering guidelines. The PJ may choose to review the state tax credit allocating agency's evaluation (of whether there are excess tax credits) to help ensure that HUD subsidies are not greater than necessary to provide affordable housing when combining HOME assistance with Tax Credits.

V. MARKET ASSESSMENT

Before committing funds to a project, the HOME Rule at §92.250(b)(2) requires a PJ to assess “the current market demand in the neighborhood in which the project will be located.” To meet this requirement, a PJ must develop and follow procedures to review a project proposal against *current* market data to address two key issues: pricing and absorption.

A PJ must have written underwriting guidelines for assessing and documenting the demand for the type and number of all housing units being developed, not just those designated as HOME-assisted. The PJ must determine whether the project can be expected to be rented or sold to within the regulatory time frames and at the cost or price estimated by the developer. Timely occupancy of HOME units by eligible tenants is critical to comply with statutory requirements as well as the sale and rental occupancy deadlines established in the regulations.

It is important to note that the market assessment required under the HOME Rule at §92.250(b)(2) differs from the needs analysis conducted for the purposes of the Consolidated Plan required by HUD at 24 CFR Part 91. The Consolidated Plan describes the general characteristics of the PJ's housing market. The HOME market assessment seeks to quantify and document demand for a specific project – that is, what is a prospective renter or buyer - willing to pay to rent or buy the unit, in this location, with these amenities, and the size of the pool of potential tenants or buyers?

The cost of a market assessment may be charged as an administrative or project delivery cost. The market assessment can take different forms, including independent market studies, waiting lists and other market information assembled by the applicant, or market data compiled by the PJ. A PJ is not required to pay for an external, independent market study or to perform a full, formal market study. The scope of the assessment should be relative to the project scope.

The PJ's underwriting guidelines must establish standards for demonstrating the evidence of *current* market demand that applicants must provide and the documentation to be used when the PJ completes an in-house analysis. HUD recognizes that data availability varies by geographical area. Consequently, a PJ must establish in its policies the data sources and age of the data that will be acceptable for its assessment. In all cases, however, the market analysis for a project should:

- Evaluate general demographic, economic, and housing conditions in the community.
- Delineate the market area by identifying the geographic area from which the majority of a project's tenants or buyers are likely to come. This may or may not coincide with census tract or neighborhood boundaries.
- Quantify the pool of eligible tenants or buyers in terms of household size, age, income, tenure (homeowner or renter), and other relevant factors. Not all residents of the market area are potential or likely tenants or buyers of any given project.
- Analyze the competition by evaluating other housing opportunities with an emphasis on other affordable rental developments or sales opportunities in the market area, including those financed through either the HOME program or other federal programs.
- Assess the market for the planned units and determine if there is sufficient demand to sell the HOME-assisted housing within nine months of construction completion (§92.254(a)(3)) or to rent the HOME-assisted housing within 18 months of project completion (§92.252).
- Evaluate the effective demand and the capture rate, usually expressed as a percentage (the project's units divided by the applicant pool). The capture rate is the percentage of likely eligible and interested households living nearby who will need to rent units in the proposed project in order to fully occupy it. The lower this rate, the more likely a project is to succeed.
- Estimate the absorption period. Plan how many units can be successfully leased or sold each month and how long it will take to achieve initial occupancy/sale of the HOME units and stabilized occupancy for the project as a whole.

In some cases, other funders may require independent market studies. A PJ may accept the independent market study prepared for another funder if the study meets the requirements outlined in the PJ's underwriting standards. However, the PJ must review any market studies or assessments and make its own conclusions about the likelihood of project success. The PJ may not simply accept the conclusion of another source as its sole evidence of market demand.

Independent or third party market studies are not required by the HOME regulations, and, in a few circumstances, may not be practical or cost-effective:

- Market studies may not be cost effective for smaller developments. For example, for existing projects where tenants are already HOME-eligible and rents are already within program limits, simplified or in-house market assessments may be more appropriate.
- Assessments for projects serving special needs can often be completed using primary data from service providers whose existing client base will form the primary pool of potential tenants.

VI. DEVELOPER CAPACITY ASSESSMENT

The HOME Rule specifies two elements of underwriting analysis related to the developer – (1) the experience and the capacity of the developer (including the entity staff and project team) to implement the project and (2) the fiscal soundness of the developer to meet its financial obligations and risks of the project. The PJ must establish policies and procedures by which they will determine what constitutes acceptable experience and financial capacity based on the size, scope, and complexity of the project, and the process by which they will make and document this determination. It is important to note that these capacity requirements apply to all developers of rental and homebuyer housing seeking HOME assistance, including CHDOs and other nonprofit developers.

A. EXPERIENCE

A PJ must assess the experience of the developer by determining whether the developer has the technical and managerial experience, knowledge, and skills to successfully complete the development. When assessing the developer's experience, the PJ should consider both prior experience and the current capacity of the organization. In considering this, the PJ must take into account:

- The corporate or organizational experience of the development entity;
- The experience of the staff assigned to the project and overall quality of the development team; and
- The prior experience of the individuals compared to their roles in the proposed project.

For rental projects, a developer/owner needs specific skills and capacity including property management, asset management, service provision (as applicable), and special financing skills.

For homebuyer projects, the development team must demonstrate its capacity to market and sell the units. This may involve the addition of a realty professional to the team, or evidence that in-house staff have the capability to oversee the advertising, unit showing, intake, and processing of potential buyers. For CHDO projects, the PJ must certify that the CHDO has paid staff with experience relevant to the proposed project and role of the CHDO.

B. FINANCIAL CAPACITY

A PJ must also examine whether the developer has the financial capacity necessary to complete the proposed project. The PJ needs to determine whether the developer has:

- Adequate financial management systems and practices; and
- Sufficient financial resources to carry the project to completion or through initial lease-up, as the case may be.

When determining whether the developer has the financial capacity to undertake the project, the PJ should examine financial statements and audits to determine the developer's net worth, portfolio risk, pre-development funding, and liquidity. Developers with limited financial resources should only be considered for projects where cash needs will not exceed the developer's net or liquid assets.

Some HOME developers may be subject to specific financial requirements. For instance, CHDOs and nonprofit subrecipients must have financial accountability standards consistent with 2 CFR 200.302 ("Financial Management") and 2 CFR 200.303 ("Internal Controls"). Other public entities seeking HOME funds as owners or developers of affordable housing may also be subject to the provisions of 2 CFR part 200 ("Uniform Administrative Requirement, Cost Principles, and Audit Requirements for Federal Awards") or other state and local requirements.

VII. PROJECT REVIEW

Before committing HOME funds, a PJ must evaluate a proposed project to ensure that funds are invested such that the project is likely to succeed over time. To verify this, a PJ must assess all of the assistance that has been, or is expected to be, made available to that project. The PJ should take into account all the factors relevant to project feasibility, which may include, but are not limited to: total development costs and available funds; impacts of HOME restrictions such as eligible costs, maximum subsidy limits, cost allocation, and rent/utility allowance limitations; rates of return to owners, developers, sponsors, or investors; resale or recapture limitations for homebuyer projects; and the long-term needs of rental projects and tenants. There are two types of documents which a PJ must review in order to assess and underwrite a project:

- A sources and uses statement; and
- An operating pro-forma. For homebuyer development projects, the pro-forma will take the form of a sales and revenue plan.

A. SOURCES AND USES STATEMENT

The HOME Rule requires a PJ to examine the development budget, commonly referred to as the "Sources and Uses" statement. A PJ's underwriting guidelines must require completion of a Sources and Uses statement, typically submitted by a developer as part of its application to the PJ. The PJ must also identify the types of documentation necessary to verify the sources and uses indicated. The Sources and Uses of Funds statement must list:

- All Sources (both private and public) of funds with dollar amount(s) and timing of availability for each source, and
- All Uses of funds (for example acquisition costs, site preparation and infrastructure costs, rehabilitation/or construction costs, financing costs, professional fees, developer fees and other soft costs) associated with the project.

1) Sources

Both the definition of commitment in §92.2 and the project evaluation requirements in §92.250 require that a PJ determine that financing sources are in place before it can commit HOME funds to a project. Consequently, the PJ should request the following for all project sources:

- Firm commitment letters with all terms and conditions for all mortgages, grants, bridge (interim) loans and investment tax credits (historical, low-income, if applicable);
- If the applicant is a partnership or limited liability corporation, a copy of the partnership agreement or operating agreement, which will indicate the cash contributions by the partner(s) or member(s); and
- If equity is committed by the developer or owner(s), evidence of available equity funds.

As part of the project sources review, the subsidy layering analysis requires a PJ to determine that the total amount of HOME assistance is reasonable and necessary. The questions that the PJ should assess when evaluating sources include:

- *Are total funding sources adequate and timely in their availability to cover development costs at all phases of the development – acquisition, construction/rehabilitation, and permanent loan?* Before committing HOME funds, a PJ must determine that all necessary financing is available to cover reasonable costs of development. PJs must review any conditions the developer must meet in order to draw funds and the schedule upon which funds will be available. The availability of sources should match the project's timeline and allow the PJ to anticipate when and for which items it will disburse HOME funds. The PJ should also review the commitment and availability of permanent funding sources, the repayment terms of which need to be incorporated in the long term operating projections.
- *Are the other funding sources compatible with HOME, or do they contain different requirements that affect the structure of the project, including unit mix, and are these differences accommodated in the project plan?* In its review of written commitments for other funding sources, the PJ must determine whether there are provisions that: (1) conflict with HOME requirements; or (2) are not reflected in the project plan. The availability of sources should match the project's timeline and allow the PJ to anticipate when and for which items it will disburse HOME funds.
- *Are the funding sources firmly committed?* The PJ must have assessed all firm written financial commitments to ensure that they are in fact firm commitments that are consistent with the PJ's underwriting of the project. Firm commitments must be non-speculative sources identified and secured in the amount necessary to complete the project. It is not necessary that financing sources have "closed" or

been disbursed. Documentation of firm financing can include award letters, offer letters, final term sheets, or other commitments which are conditioned upon the receipt of HOME funds. But, these may not include automatic self-expiring clauses or highly conditioned language and must have all substantial terms tied to a specific project.

In the case of projects with LIHTC, the project must have received a reservation from the Housing Credit Allocator (e.g., State Housing Finance Agency) and be able to provide a good faith offer of equity investment from an investor prior to the issuance of a HOME commitment.

2) Uses

Uses are the project costs that are budgeted to be paid during the development phase. A PJ must review all costs of the project because the determination of the amount of HOME assistance needed is based on the gap between uses and other sources. Even costs not being paid with HOME funds must be necessary and reasonable, as the inclusion of excessive costs inflates the apparent need for public subsidy in a project.

In its review of the Sources and Uses statement, a PJ should assess the detailed breakdown of costs, including all hard and soft costs of the project, and review documentation or explanations of the basis of the calculation. PJs should require applicants to provide project budgets in sufficient itemized detail to evaluate not only the sufficiency of the budget but also to evaluate whether project costs are reasonable both on a line item basis and in the aggregate. If the documentation is not adequate and does not support the costs as stated, the PJ should request additional documentation, a second opinion and/or reference from the appropriate source (i.e., another construction cost estimator, another architect or lawyer), or deny the project HOME funding. Note that for projects with tax credits to be sold, the proceeds from the sale of these credits must be identified as a source of funding.

The PJ will need to request and review documentation for all line item costs in the budget, including:

- Acquisition documentation, such as purchase agreement, option or closing statement and appraisal or other documentation of value;
- Construction cost estimate, construction contract or preliminary bid(s);
- Contracts, quotes or other agreements substantiating key professional costs and the basis for estimating other soft costs and working capital items, including capitalized reserves;
- Agreements governing the various reserves which are capitalized at closing (to verify that the reserves cannot be withdrawn later as fees or distributions);
- A third-party appraisal (to substantiate the value of the land and the value of the property after rehabilitation or the structure being built);

- If LIHTC are utilized, documentation on the syndication costs (legal, accounting, tax opinion, etc.) from the organization/individual who will syndicate and sell the offering to ensure that the project can support the fees necessary to syndicate/fund the project.
- Note that for homebuyer projects, some of the costs – such as realty fees, closing costs and some of the developer fees – will not be incurred until the closing and might be paid out of closing proceeds. Also, since the development phase loans such as construction loans are repaid at time of sale from sales proceeds, the estimation of the period to sell and close on the units is an essential part of the analysis. Again, this is affected by the ready presence of buyers under agreement or in the counseling/screening pipeline. A PJ should make certain that the developer has projected interim financing interest and carrying costs to reflect the expected project absorption.

The PJ's review of project uses needs to address the following questions:

- *Are all of the proposed costs of development “necessary and reasonable” in compliance with OMB cost principles contained in 2 CFR part 200?* Costs are considered “necessary” if they are required to implement the project in full compliance with all program standards. According to 2 CFR part 200, a cost is reasonable if it “does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost.” The determination of reasonable cost should include the following factors:
 - Costs of comparable projects in the same geographical area
 - The qualifications of the costs estimators for the various budget line items
 - Comparable costs published by recognized industry cost index services.
- *Are the proposed costs sufficient to achieve all program requirements, including property standards, to provide quality housing for at least the affordability period?* PJs must ensure that the project budget is adequate to meet and maintain the property standards of §92.251 and all other HOME and cross-cutting federal requirements that apply to its development. The completion of a capital needs assessment or estimate of the property's useful life is essential to this analysis in rehabilitation projects.
- *Are the costs proposed to be paid with HOME funds eligible under the HOME rule?* Refer to the HOME rule at §92.206 for additional guidance on eligible costs.

B. OPERATING PRO FORMA

The PJ must require the rental project applicant to furnish an operating pro forma (project income and expense statement) projected for the HOME period of affordability at a minimum. The PJ's underwriting and subsidy layering guidelines will need to establish minimum criteria for the content and/or format of the pro-forma.

A PJ must evaluate the reasonableness of the financial assumptions of the project to establish minimum total per unit operating costs. To do so, the PJ should evaluate the sufficiency of both specific line item and total operating costs. A PJ should also ensure that long-term operating projections over the period of affordability are based on reasonable assumptions and demonstrate that project can cover expenses and debt service throughout the affordability period.

It is imperative that the PJ scrutinize the pro forma consistent with its written guidelines and to ensure the cash flow projections are realistic in light of economic conditions. The cash flow projections should be neither unduly conservative nor overly optimistic. It is the PJ's role to balance the need for public subsidy to make the project viable while safeguarding the investment of HOME funds in the project by ensuring that projected income and expenses are reasonable, and provide resources that are sufficient for the property's upkeep and planned capital repairs during the affordability period.

Long-term operating projections should be based on reasonable assumptions about how revenues and operating costs are expected to change over time, and demonstrate the project is expected to operate within normal operating parameters throughout the affordability period. A PJ should assume that operating costs increase at a faster rate than revenues.

1) Projected Income

Operating revenues must be based on achievable rent levels, reasonable vacancy and collection loss, and conservative estimates of non-residential sources of incomes.

- In most projects, non-residential revenue from fees/late charges, commercial income, interest, laundry/vending, or other similar sources likely will be modest, therefore should be projected conservatively.
- Even in strong rental markets, HUD recommends setting initial rents somewhat below program limits or projected market rents because HOME rents may not increase as rapidly as market rents.
- Vacancy projections should reflect local market conditions and account for both physical vacancy and collections loss.
- The rate of projected growth for rental income and other revenues should be appropriate to the local market and regulatory limits.

- In projects with deeply targeted rents, lower than average rates of revenue increase should be used, as utility allowances will surpass rent increases. Net Operating Income (gross revenue minus operating expenses) should be sufficient to cover debt service obligations and mandatory replacement reserve funding and generate reasonable but not excessive Cash Flow throughout the period of affordability. If deficits are projected, the HOME subsidy may be increased to reduce amortizing debt and the deficit reserves might be funded from other sources.

2) Projected Expenses

All operating costs must be in sufficient detail to compare line items against properties that are similar in physical type and size, so that the PJ may determine whether the planned expenditures are sufficient and reasonable. The operating budget should include general management expenses, maintenance and operating costs, any project paid utilities, taxes, insurance premiums, and adequate deposits to replacement reserves. In most cases, evaluation of total operating costs should be summarized in “per unit per year” amounts rather than as a percentage of projected revenue.

- Most operating costs (e.g. water/sewer rates or lawn mowing) do not vary based on how much tenants are paying in rent. Whenever possible, the PJ should compare against other projects in the property manager’s portfolio or the neighborhood.
- Management and other fees to the owner should be reasonable in the local market.
- The identity of interest (also referred to as related party) relationships with contracted property management, repair/rehabilitation contractors, or other project vendors must be disclosed.
- Minimum replacement reserve deposits should be specified based on the characteristics of each project. Reserve needs may vary based on the type of physical product, the target population, and whether the building is newly constructed or rehabilitated.
- Any debt service or other funding/reserve requirements related to ‘secondary’ financing in mixed financed deals, if applicable.
- Cash flow should be evaluated both as a “debt coverage ratio” and as a percentage of operating costs and debt service.

C. SALES PLAN – HOMEBUYER PROJECTS

In lieu of an operating pro-forma, a PJ must request a sales plan from homebuyer developers (which may also be evaluated as a component of the market assessment). This sales plan should indicate the developer’s anticipated cash flow and timing of when and how units will be sold. A PJ should evaluate the sales plan for:

- *Timelines:* Analyze the speed that the developer anticipates selling homes. Is this realistic given the market?
 - Overall supply in the market and how many months of supply that represents (a 4 – 6 month supply is often considered a stable market.) A PJ should also examine listing times, and the foreclosure and shadow (delinquent but not foreclosed) inventories.
 - Other affordable homeownership options already available, including projects in the pipeline.
 - The price, location, amenities and financing of units that are most directly comparable with the housing proposed. Pricing needs to be competitive and locational factors can offset the program advantages.
- *Cash flow:* A PJ should analyze the developer’s intended plans for use of the sales revenues.
 - Is the developer counting on obtaining previous sales revenues before they begin construction on the next for-sale unit? If yes, does this cause concerns for the HOME timeliness requirements for the entirety of the project? How is the project affected if the first units are slow to sell or sell at a lower price than anticipated?
 - As discussed further below, is the anticipated return to the developer from the sales revenue reasonable or should the PJ require some of these proceeds be returned to the PJ as program income?

D. PROFIT AND RETURNS TO DEVELOPER

The HOME regulations at (§92.250(b) require that any profit or return on the owner’s or developer’s investment will not exceed the PJ’s established standards. This analysis includes profit that is projected to flow to the developer as operating cash flow from rental projects, sales proceeds from homebuyer units (if not considered as program income by the PJ) and any other professional fees being paid to the developer or related entities. The PJ’s underwriting guidelines must include a standard for determining a limit for overall returns and cash flow distributions to ensure that owners do not receive excessive gains/profits from the project as a result of HOME and other public subsidies.

Developers and owners may financially benefit from HOME-assisted projects in several ways:

- **Developer Fees:** These are fees charged by the developer as a part of the project cost to compensate for the risk, time and effort to build and sell or lease the property. Developer fees are allowed under the HOME program, but the PJ must review these fees and determine that they are reasonable. A PJ may set limits on the developer fee that differ from other funding sources (e.g. LIHTC underwriting standards). A PJ

should establish developer fee schedules or ranges that reflect the local market and consider the following:

- The scope and complexity of the project being developed;
 - The size of the project;
 - The relative risk the developer is taking;
 - The costs a developer will incur from the fee as compared to those being charged as project costs;
 - The fees that are regularly and customarily allowed in similar programs and projects; and,
 - Other fees the project is generating for the developer and its related entities.
- **Sales revenues:** Developers of for-sale properties may keep some or all of the sales proceeds, as deemed reasonable by the PJ.
 - **Cash-Flow:** Assuming that the rental property is properly structured and financed, successfully attracts residents, and is effectively managed; the project likely will have net cash-flow after the payment of debt service. Cash-flow is distributed to the owner and/or investors as a return on their original investment.
 - **Tax Benefits:** Rental owners and/or investors can also benefit from tax savings—a reduction in the income taxes they owe due to tax losses or tax credits.
 - **Equity Appreciation:** Over time, the value of the rental project sponsor/owner's ownership share in the project will increase as debt financing is paid down (due to the portion of debt service that is applied to the loan principal), and depending on market conditions, the property appreciates in value.
 - **Identity of Interest (IOI) Roles:** Some developers may also own construction companies and if this company is used for the HOME project, the construction firm may earn reasonable profit and overhead as a component of the development budget. If the rental property owner also operates a property management company contracted to service the property, the developer may earn fees from those activities. These and other IOI contracts require additional scrutiny by the PJ to make sure that they are clearly disclosed, priced at arms-length rates, and subject to cancellation if the IOI contractor does not provide acceptable service.

The PJ should also consider how the sales revenues will be distributed, especially if the HOME assistance was provided as a grant to the developer or if the unit sells for more than the development cost.

Profit from rental project operations must be analyzed and determined to be reasonable. The simplest evaluation is the cash flow return on the investment. The cash-on-cash rate of return

simply measures the annual cash-flow that is distributed to an investor as a percentage of the funds invested (Annual Cash Flow/Equity Invested = X%). An evaluation of what constitutes an acceptable rate of cash-on-cash return depends upon the perceived level of risk in the project (is cash flow actually going to be there) and the level of return available in other investments (e.g., what is the going rate on lower risk investments such as Treasuries).

Another approach to assessing developer profit is to assess the Internal Rate of Return (IRR). IRR expresses all future benefits (cash, tax savings, and profit from sale of property) as an interest rate that the owner or sponsor is determined to be earning as a percentage of total cash invested in the project. The IRR technique adjusts for differences in timing and differences in amounts of future benefits and reduces the entire stream of benefits (initial investment, annual cash flow, expected future resale/refinancing proceeds) to a single interest rate.

For project where developers do not actually invest equity into a project (other than that from the syndication of tax credits), returns may be evaluated against guidelines on reasonable per-unit per-year cash flow allowances, and can be controlled by: requiring annual installment payment on HOME loans; requiring reduced rents on affordable units to serve lower-income tenants, or other means. A PJ should establish standards related to the use and distribution of project cash flow, including payment to reserves, payment of related party fees (e.g., asset management fees, investor service fees, incentive or performance fees) to the developer or owner, and the relative priority of distribution for net cash flow.

VIII. ESTABLISHING THE LEVEL OF HOME SUBSIDY (SUBSIDY LAYERING)

The analysis to determine the amount of investment needed to make a project feasible is sometimes referred to as “gap analysis”, as it is used to determine the gap between approved costs (Uses) and available financing and other subsidies (Sources). The gap is influenced by many factors, some of which can be modified prior to commitment, including:

- Level of physical improvements;
- Rent levels and affordability;
- Income levels being served (e.g., a target population of 60 percent of median income could require less assistance than if the target population is below 30 percent of area median income); and
- Payment terms of all funding, including HOME and other public funding.

In addition to conducting the subsidy layering review described above, before committing HOME funds to a project to help fill the financing gap, the PJ should:

- **Evaluate Debt Capacity.** Make sure that the lender’s financing terms are reasonable and comparable to those available from other lenders.

- Are other lenders willing to finance at a higher loan to value ratio (LTV)?
- Are other lenders willing to finance at a lower debt coverage ratio (DCR)?
- Is the interest rate competitive with what other lenders are willing to offer?
- **Evaluate Equity Contributions.** Evaluate the full spectrum of returns that are accruing to owners and investors. If it appears that the project is returning a higher level of return than is warranted given project risk and market conditions, then the PJ can require additional equity investment (or reduce the level of HOME assistance). Also, evaluate the calculations of tax credit basis and market price to determine if the projected amount of tax credit equity is reasonable.

If the total amount of HOME assistance and other sources exceeds the amount that the PJ determines is necessary to make the project feasible and viable for at least the affordability period, the PJ may consider:

- Reducing the amount of HOME assistance;
- Increasing the number of HOME assisted units in the project or lowering the target income levels and rents to be charged; and
- Imposing loan terms that bring the rate of return into line with standards.

The PJ should deny HOME assistance if the applicant refuses to make reasonable adjustments or to limit its return/costs in compliance with underwriting guidelines or if it appears that HOME funds are not needed to close a financing gap. While a PJ will identify the amount of subsidy needed through gap and other project analysis, the PJ must also determine that the amount of HOME assistance needed will be used on program-eligible costs or activities. As noted above, HOME funds are capped by two important measures:

- Total HOME-eligible costs allocable to assisted units; and
- The maximum subsidy as permitted by regulation for the assisted units (based on unit size).

IX. UNDERWRITING TO PROMOTE SELF-SUSTAINING PROJECTS

HUD encourages the PJ to build into its underwriting and subsidy layering procedures underwriting principles that promote long-term financial viability and self-sustaining operations for assisted projects during their HOME affordability periods. Whether a project can remain viable and self-sustaining over time partly will depend on whether the project:

- Can accommodate moderate “income shocks” such as an increase in vacancy;
- Can accommodate moderate “expense shocks” such as an increase in utility rates; and

- Can self-fund its major repairs and replacements (“capital needs”) from a combination of its Reserve funds, its cash flow, and future refinancing.

To do so, the PJ, the owner or sponsor, and any other subsidy providers need to approach the underwriting process in a way that helps to assure:

- Gross potential rents that are actually achievable, taking into account location, design, and intended resident population.
- An allowance for rent loss (vacancy, bad debt, and concessions) that reflects the likely long-term average the property can be expected to achieve.
- Underwritten operating expenses that are likely to be adequate to allow a competent management agent to operate the property successfully, in a typical year.
- Trending factors for income and expenses that are reasonable and prudent.
- Sufficient debt service coverage to allow the property to survive income and expense shocks.

Reserve funding that, when combined with reasonably foreseeable future cash flow and reasonably foreseeable future refinancing potential, will be adequate to meet the property’s capital needs over the HOME affordability period.

X. DOCUMENTING COMPLIANCE

The HOME regulations require a PJ to develop and follow procedures for documenting all elements of the required underwriting and subsidy layering analysis— e.g., who submits the documentation, when it was submitted, etc. (92.508(a)(3)(iii)). Each project file must contain the required project evaluation, demonstrating that the PJ’s guidelines have been applied to the project. In order to document compliance with this requirement, the PJ must affirmatively review and approve the underwriting and subsidy layering analysis with dated signatures. The written agreement must reflect- project underwriting. If changes are made to underwriting or subsidy layering during the development period, the PJ must update its written agreement and project file documentation.