National Development Council

Partners in Community Development Since 1969

Improving Communities - Enhancing Lives

NDC is the nation's oldest non-profit provider of community development technical assistance and training

Makah Commercial Fishing Dock, Olympic Peninsula, Neah Bay, Washington

A Powerful Mission

Increasing the flow of capital for investment, jobs and community development to distressed urban and rural communities

throughout

the U.S.

Historic Franklin Building
Affordable Apartments,
Watertown, New York

Evaluating A Project’s Need for Public Gap Financing Assistance:

NDC’s Approach




Collaborative Architects, PC

Defining the "Financing Gap"

- **A project's financing gap is defined as the difference between projected costs (uses) and the debt and equity (sources) it can reasonably attract as follows:**

Total Project Costs

- Bank Loan

- Equity

= Financing Gap

A Fundamental Problem in Real Estate Finance

- Total Project Costs (TPC) are often greater than a project's Fair Market Value (FMV) as Completed
- But...debt and equity are a function of value, not cost
- Where TPC > FMV, there's often a need for public economic, housing and community development resources to get the project done

Cost-Value Differential Example

Mixed-Use Development		
Residential Units		60
Commercial Retail Space		40,000
Project Costs		Fair Market Value
$20,000,000		$10,000,000
Project Costs		$20,000,000
Debt (75% of FMV)		$7,500,000
Other Sources Needed		$12,500,000

Why Some Projects Require Public Assistance?

- Project Costs > FMV
- Investors see inadequate Return on Investment (ROI)
- Lenders see unacceptable levels of risk

Hughes-Irons Mixed-Use Project, Council Bluffs, Iowa

Investor's Perspective

- Investors/Developers seek to maximize economic benefits and minimize their equity investment
  - Looking for projects yielding the highest (ROI)
  - Investor returns are subordinate to debt service on loans and other obligations (property taxes, operating expenses, etc.) – so returns need to reflect risks

Lender's Perspective

- Lenders are risk limiters, not profit maximizers
- Lending is a low-margin, high-volume business
- No "upside" for lenders – Fixed Returns
  - Marginal return on investment (interest)
  - Expected return of investment (principal)
- Will participate - but want to mitigate all risks

Defining the Financing Gap

Project Costs – are they reasonable & adequate?

- **Bank Loan – maximized given lender terms?**
- **Equity – fair return without undue enrichment?**

Gap – are there public sources available to close?

Historic East Side Suites
Lancaster, Pennsylvania

Maximizing Debt Attraction

- A Project's maximum loan amount will be determined by the lender's primary underwriting criteria:
  - Debt Coverage Ratio (DCR)
  - Loan to Value Ratio (LTV)

And, by market interest rates and terms (amortization schedules) and opinions of value established by an appraiser

Maximizing Debt Attraction (cont.)

- For example:
  - Bank is offering:
    - 6% financing with 25 year amortization
    - Minimum Debt Coverage Ratio (DCR) of 1.25:1
    - Maximum Loan To Value (LTV) of 75%
    - Appraiser sets Capitalization Rate at 7%
  - Project has:
    - Stabilized Net Operating Income (NOI) of $250,000
    - TPC is $3,650,000

Maximizing Debt Attraction (cont.)

- Given the information above, the Maximum Loan:
  - By DCR - $2,586,781
  - By LTV - $2,678,571
  - Bank will offer the lower of the two loans so that each underwriting criterion is met: offered loan - $ $2,586,781
  - Annual D/S will be $200,000
  - TPC – Maximized Debt = $1,063,219

Maximizing Equity

- Difference between project costs and maximum loan is $1,063,219
  - Does the Developer and partnered investors have the necessary resources to close the gap?
  - Is it reasonable for the Developer to invest enough to close the gap?
  - Year 1 CF = NOI ($250,000) – D/S ($200,000)
    Year 1 CF = $50,000

Maximizing Equity (cont.)

- Developers seek three benefits when investing in real estate:
  - Cash Flow (CF)
  - (Revenues – Operating Expenses – Debt Service = CF)
  - Tax Benefits (Depreciation, Tax Credits, etc.)
  - Appreciation (Net Proceeds at Sale or Refinance)
- These benefits over all the years the Developer holds the property – with final appreciation benefit taken at its sale

Maximizing Equity (cont.)

- **Investors demand a return on their money given their perception of:**
  - **Risk**
  - **Inflation**
  - **Opportunity Costs**
- **These three factors determine the discount rate. The discount rate converts future benefits to a present value and equals the investor's desired Internal Rate of Return (IRR)**

Maximizing Equity (cont.)

- If the Developer and partnered investors for our example want a 11% IRR – given projected Cash Flow, Tax Benefits and Appreciation - they'll only invest $670,000

• Project Costs	$3,650,000
- Bank Loan	$2,586,781
- Equity	$ 670,000
= Gap	$ 393,213

Closing the Gap

- Abate or Rebate a portion of new (incremental) property – and/or other - taxes generated by the Project to:
  - Increase potential debt capacity
  - Increase attracted equity
- Attract additional equity with federal or state tax credits
  - New Markets Tax Credits
  - Low Income Housing Tax Credits
  - Historic Rehabilitation Tax Credits

Closing the Gap (cont.)

- Reduce Project costs through:
  - Value engineering Project specifications
  - Public assumption of select Project costs:
    - Sidewalks
    - Donated or discounted land
- Offer Subordinated Public Loans to:
  - Increase debt capacity
  - Lower equity requirements and raise ROI
- Identify and secure scarce federal and state grants

NDC

820-826 Pennsylvania

	Amount	% of Total
Total Project Costs	**$3,622,795**	**100.00%**
Project Sources		
Projected Bank Loan	$3,013,000	83.17%
Required from Developer	$609,795	16.83%
Total Sources	**$3,622,795**	**100.00%**

- **Projected Internal Rate of Return:**
  - **With NRA and IRB incentives: 9.85%**
  - **With just NRA incentives: 8.51%**
  - **With Just IRB incentive: 7.99%**
  - **With no incentives: 6.98%**

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For more information

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