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Affordable Housing

Using Sec. 538 to Revitalize your Sec. 515 Property

By Carl W. Wagner

In January the U.S. Department of Agriculture issued a Notice of Funds Availability (NOFA) that permits use of the Sec. 538 program to fund the needs of USDA Sec. 515 portfolios. This change offers new opportunities for both existing owners and new owners by creating a funding source for rehabilitation and preservation of affordable rural housing.

New Owner, Same Loan

A 28-year-old property built in 1977 using a USDA Sec. 515 loan with a Housing Assistance Payments (HAP) contract faces an acquisition/rehabilitation project. The Sec. 515 loan has a \$375,000 balance at a 1% interest rate.

Previously, a new owner could not combine Sec. 515 and Sec. 538 loans; however, with the release of the new NOFA, the property's new owner utilizes a USDA Sec. 538 loan to assume the existing Sec. 515 loan at 1% effective interest and preserves the property's rental assistance. The owner combines the Sec. 538 program with a variety of additional funding sources – including soft loans, deferred developer's fees, and 9% LIHTC – to accumulate \$4.2 million in capital funding.

By utilizing the Sec. 538 program, the new owner generates \$3.8 million in repair funds, allowing for much-needed general rehabilitation and the addition of a new community room and laundry facilities. All this is accomplished without raising tenants' effective rents.

Preserving America's Affordable Housing

The change in the 2006 NOFA is an integral part of the overall "Preservation Program" for the Sec. 515 portfolio. Congress already provides various preservation tools, including direct loans from Rural Development and loan restructuring authorities. But Rural Development simply lacks the resources to take on the entire revitalization program: Of 17,000 properties and 450,000 units, two-thirds are more than 20 years old. The new abilities to use the Sec. 538 program with Sec. 515 properties involve private lenders in the revitalization process, injecting private funds into the capital-intensive process of preserving affordable rural housing.

Maintaining Ownership

Prior to the NOFA, only new owners of Sec. 515 properties

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could use the Sec. 538 program to rehabilitate, necessitating a sale of the property to qualify for the funding. Under the new notice, however, owners of Sec. 515 complexes can utilize Sec. 538 funding to repair existing projects, and purchasers of Sec. 515 properties also can use Sec. 538 funding to make needed repairs to that property.

How Does It Work?

The NOFA authorizes Rural Development to subordinate existing Sec. 515 loans to the new Sec. 538 loans. In addition, interest assistance reduces the interest rate on the Sec. 538 loan to the Applicable Federal Rate (AFR), less than 5% at present. Furthermore, Rural Development will permit a rent increase in some markets and consider deferral of existing Sec. 515 payments in some situations to provide the necessary income to make payments on the new Sec. 538 debt. Other options may be available to individual owners depending on their financial situations.

Improved Benefits for Existing Owners:

- No Change In Ownership
- Extend Loan Term
- Opportunity to Improve Interest Rate
- Defer Payment

Improved Benefits for New Owners:

- Preserve Existing Rental Assistance
- Match Market-Rate Rents
- Minimize Agency Oversight
- Maintain "Old and Cold" Debt

Reviewing Options

This new funding source will not work for every property or every owner, but it is an opportunity for many owners to revitalize and rehabilitate. The process will involve a new-use restriction on properties applying the funding source, and these properties will make payments on an additional loan with an annual guarantee fee. Conventional lenders will make and service the Sec. 538 loans.

Maintain Ownership, Preserve Assistance

A 31-year-old affordable housing property funded with a USDA Sec. 515 loan and a 75% rental assistance contract is in dire need of rehabilita-

tion. The Sec. 515 loan has a \$560,000 balance at a 1% effective interest rate.

Because this project has 75% rental assistance, the owners need to offset a rent increase to avoid significantly raising tenants' effective rates. Traditionally, Sec. 515 loans could not be refinanced without a change in ownership; however, with the release of the new NOFA, the existing owner of the property utilizes a Sec. 538 loan to reamortize and extend the term of the Sec. 515 loan, thereby preserving rental assistance.

Furthermore, \$4.6 million in repair funds – from sources including soft loans, deferred developer's fees, and 9% LIHTCs – are used to replace electric furnaces with a propane system and install new windows, doors and insulation, lowering operating and maintenance costs. Without a change in ownership, the owners accomplished their goals and avoided significantly increasing tenants' effective rents.

Prepare and Act

The NOFA will have an approximate total funding limit of \$100 million. This means that a limited number of borrowers will be able to take advantage of the 538 program this year, so action is necessary in the first quarter of 2006.

Contact Lancaster Pollard to arrange a prompt, thorough review of your current portfolio, and determine your Sec. 538 options today.