

Refinancing post-1973 Sec. 202 properties requires ingenuity

By William C. Kelly Jr.

Responding to deferred maintenance and the aging-in-place of residents, sponsors of Sec. 202 housing for the elderly have begun to recapitalize the properties they built under the versions of the program in effect between 1959 and 1990, all of which involved a government loan to nonprofit sponsors. The Department of Housing and Urban Development (HUD) does not track the refinancings, but industry observers estimate that there have been between 200 and 250 to date, mostly of small projects. This activity is no more than a hint of what is on the horizon.

The spread between the high interest rates on existing Sec. 202 loans and the lower rates available in today's market likely will drive a boom in refinancing over the next decade with new insured debt and, in some cases, low-income housing tax credit (LIHTC) equity. Sec. 202 loans have a combined principal balance of more than \$7 billion, secured by 4,369 properties comprising 241,287 apartments.

Loans made between 1959 and 1973 and now outstanding on 292 properties carry interest rates from 0% to 6%, with most between 3% and 4%. HUD neither imposed income limits on these properties nor provided rental assistance. In most cases, project documents allow prepayment without HUD approval.

Interest rates on loans made after

program revisions in 1974 and now outstanding on 4,077 properties range from 6.25% to 9.25%, with more than half at the top of that range. These properties have income limits for residents and Sec. 8 contracts, reflecting a redirection of the program to serve solely low-income seniors. Seniors at these developments pay 30% of their incomes as rent.

Recent HUD policy changes ease the process of prepayment and refinancing for

write new loans based on above-market Sec. 8 rents.

The key remaining regulatory barrier to debt refinancing is a requirement, applicable to every property with a loan subject to prepayment approval under Notice H2002-16, for a long-term use agreement that runs with the land and effectively extends to the original maturity date of the Sec. 202 loan. The required form of use agreement limits occupancy

to very low, low- or moderate-income seniors or disabled persons; must be recorded ahead of the new financing; runs with the land; and effectively limits rents to 30% of a resident's income even if the government stops providing Sec. 8 rental assistance.

Because most Sec. 202 residents have very low incomes, these rents would not cover operating costs, much less debt service. Unless and until HUD revisits this rent restriction, most debt refi-

nanings of properties subject to approval under Notice H2002-16 are likely to use FHA insurance.

Another problem is small deal size. Fees and other transaction costs could consume most of the savings from interest-rate reductions, especially in light of the small size of many of the properties. Creative strategies are helping to address that problem.

In Maine and North Carolina, GMAC, with HUD's cooperation, arranged financing that cross-collateralizes small

Woodbridge Manor
in Irvine, Calif.



post-1973 loans. Some loans, typically those approved between 1977 and 1982, are prepayable as of right under the loan documents. Otherwise, the owner must obtain HUD's approval under the procedures of Notice H2002-16, as amended by HUD Notice 04-21, which was issued Nov. 12, 2004 (see *Affordable Housing Finance*, January 2005, page 22). The amendments remove many of the regulatory barriers that bottled up demand, notably allowing Federal Housing Administration (FHA) lenders to under-

properties, reducing transaction costs and supporting investment-grade ratings on Sec. 501(c)(3) bonds.

The Maine transaction involved a merger of 11 affiliated owners spread around the state. Bonds issued by the Portland Housing Development Corp. earned a Baa2 rating from Moody's Investment Services without credit enhancement. The owner netted \$2.9 million for the property and its exempt purposes.

In North Carolina, the owners of 179 group homes affiliated with ARC of North Carolina formed an obligated group, all pledging their assets to back \$35.9 million of Baa1-rated bonds issued by the state Medical Care Commission. A reduction in the interest rate from 8-7/8% to 5-5/8% yielded \$4 million for sprinklers and other rehabilitation and provided multi-year funding for service coordinators. To save time and money, the parties posted the voluminous documents on a Web site.

Use of LIHTC equity in Sec. 202 recapitalizations remains difficult. Only a handful of these LIHTC investments have closed. Notice 04-21 removes an artificial cap on developer fees and allows LIHTC equity to count as equity for purposes of the allowable return on equity. However,

for recapitalizations subject to approval under Notice H2002-16, the use agreement may continue to chill the equity markets as investors worry that the use agreement's rent restrictions would remove all viable options in the event of a non-renewal of a property's Sec. 8 contract.

One early success was the recapitalization of Woodbridge Manor in Irvine, Calif. Bond proceeds and 4% LIHTC equity arranged by Red Capital Group funded substantial rehabilitation of 150 units, construction of 15 new units, and a service coordinator's salary. As is fairly common in California and the Northeast, Sec. 8 rents were below market. HUD marked the Sec. 8 rents up to market and enhanced the bonds with FHA insurance under Sec. 221(d)(4). A developer fee will enable the nonprofit sponsor to construct more affordable housing in its own community.

In most areas of the country, however, Sec. 8 rents exceed market rents. For those markets, conventional lenders and LIHTC equity investors are concerned about the possibility that Sec. 8 rental assistance will not be available for the term of their loans or the 15-year tax credit compliance period.

When the original Sec. 202 sponsor lacks the capacity to recapitalize a proper-

ty, a more sophisticated sponsor may step in. A partnership controlled by National Church Residences acquired Kirby Manor, a dilapidated, unassisted Cleveland property that was built in 1969 with the proceeds of a 3% loan. Of the 202 units, 138 were efficiencies with chronically high vacancy rates. With the proceeds of bonds insured under Sec. 221(d)(4) and arranged by Love Funding and approximately \$9 million in LIHTC equity provided by the National Affordable Housing Trust, after closing the partnership will combine the efficiencies into one-bedroom apartments and will add an additional 48 apartments. A \$1 million reserve cushions the residents against rent increases.

A long-needed process of recapitalization is now under way. With creativity on the part of owners and capital providers and additional flexibility from HUD, there is every reason to believe that the Sec. 202 portfolio can be rehabilitated and updated to meet the needs of its increasingly frail population. ■

Bill Kelly is the president of Stewards of Affordable Housing for the Future (SAHF), an umbrella group of national nonprofits dedicated to preserving the affordability of low-income housing. For 25 years, he was a partner at Latham & Watkins, LLP, in Washington, D.C.

Housing Partnership Network hits the 10,000-home mark

Boston—The Housing Partnership Network is looking forward to further growth this year after a strong performance in 2004.

The nonprofit organization recently helped develop or preserve its 10,000th home. It reached this milestone with a \$235,000 predevelopment loan that will help the Community Preservation and Development Corp. (CPDC) preserve Zion Tower, a 211-unit affordable seniors community.

In four years, the Housing Partnership Fund, a lending affiliate of the Network, has made approximately 70 loans totaling more than \$30 million to 25 Network members for acquisition and predevelopment expenses.

About two-thirds of the financing provided has gone to preservation deals, said Tom Bledsoe, president of the Network and the Fund.

The partnership was formed in 1990 by some of the most experienced and entrepreneurial nonprofit housing leaders in the nation to pioneer new approaches and improve the production of affordable housing. There are now 84 organizations in the Network.

The organization has doubled its size since 2002 and is exploring the possibility of raising additional financing. It has typically offered two types of financing: loans for those looking to develop a product, and predevelopment loans. Bledsoe said it will be targeting more predevelopment loans.

Looking ahead, the Network is exploring the possibility of doing bond financing.

"We will be looking for opportunities to do more," said Bledsoe, citing 2004 as one of the Network's best years. In addition to its financing efforts, the Network established the first private insurance company owned and operated by nonprofit affordable housing organizations.

The group's entrepreneurial spirit and business acumen earned the Network a 2005 Social Capital Award from *Fast Company* magazine and the Mortgage Institute.

Leslie Steen recently joined the Network as vice president for policy and business development. The former head of CBO's Steen brings preservation and other experience to the Network.

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